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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1932

No. 779

CENTRAL KENTUCKY NATURAL GAS COMPANY,

Appellant,

*v.*

RAILROAD COMMISSION OF KENTUCKY, MOSES R. GLENN, OSCAR VEST, and JAMES HATCHER, Members Constituting said Railroad Commission, BAILEY P. WOOTTEN, Attorney General of the Commonwealth of Kentucky, CITY OF LEXINGTON, a Municipal Corporation, and S. B. FEATHERSTON, individually and as representing all other persons similarly situated,

Appellees.

## BRIEF FOR APPELLANT

### Jurisdiction

The company, pursuant to Rule 12, paragraph 1, has filed its statement as to jurisdiction, and this

Court has found that probable jurisdiction has been shown (.... U. S. ....; Order entered March 27, 1933). No opposing statement as to jurisdiction has been filed.

## Statement of the Case

### 1—The Parties

The appellant, Central Kentucky Natural Gas Company, is a Kentucky corporation, engaged in the business of producing, purchasing and marketing natural gas. The appellee, City of Lexington, is a municipal corporation of Kentucky. The appellee, S. B. Featherston, is a gas consumer appearing for himself and other consumers generally. The appellee, Bailey P. Wootten, is the Attorney General for the Commonwealth of Kentucky. The remaining appellees are members of the Railroad Commission of Kentucky.

### 2—How a Franchise May Be Obtained

Under the Kentucky Constitution the streets of a city can not be used by a public service corporation without the consent of the city's legislative board (Kentucky Constitution, Section 163, Appendix, p. 90), such privilege can not be granted for more than twenty years, and must be sold at public auction to the highest and best bidder (Kentucky Constitution, Section 164, Appendix, p. 90).

### 3—Conditions Existing Under Former Franchise

The appellant obtained a twenty year franchise in 1905 from the City of Lexington to use the streets for its mains and equipment in supplying natural gas. This franchise

expired September 5, 1925. Negotiations for a new franchise followed, and resulted in the adoption by the city of Ordinance No. 3346 (R. 31 to 40), authorizing the Mayor to sell at public auction a twenty year franchise on the terms and conditions of said ordinance. This ordinance, referred to as the Franchise Contract, was adopted on January 28, 1927. The terms of the ordinance were the result of advance agreement between the city and the company, and was drawn to fit the situation and facts affecting appellant. The franchise was sold at public auction, and appellant's bid was accepted by the city on February 25, 1927, upon which date the franchise contract became effective (R. 4).

The city and the company were unable to agree on rates and for that reason the franchise contract merely provided for just and reasonable rates and charges, Section 4(A) (R. 32), but provided the method for fixing rates, Sections 4(B) to 4(E) inclusive (R. 32-33).

After the company acquired the original franchise in 1905, it built a main ten-inch transmission line to the gas field owned by it in Menifee County, Kentucky. In November, 1912, by reason of the rapid depletion of this field the company entered into a twenty-year contract (R. 177) with the United Fuel Gas Company, a West Virginia corporation, to deliver gas to the company at Inez, Kentucky (near the West Virginia boundary) and extended its ten-inch main to that point in order to receive this gas.

Subsequently the company entered into contracts with other companies owning gas fields along its main transmission line for delivery of gas at various points (R. 177). In 1922 the company acquired leases on various gas lands in Lawrence County, Kentucky, known as the Red Bush field (R. 118a).

The company had been unable to furnish gas through its ten-inch line in sufficient quantities to meet peak demands in very cold weather, causing much inconvenience, discomfort and dissatisfaction. During the negotiations for the new franchise the insufficiency of its main line was stressed. In the meantime Petroleum Exploration, a corporation, had discovered and developed a considerable gas field in Owsley County, Kentucky, about fifty miles from Lexington.

**4—The New Franchise and Its Provisions**

For the purpose of compelling the company to secure this additional supply of gas the city wrote into the franchise ordinance Section 23 (R. 36) requiring the company purchasing the franchise, if it already had a ten-inch main transmission line (this applied to appellant) to begin within six and complete within nine months thereafter an additional line to adequate sources of supply in Kentucky or West Virginia so as to enable it to comply with the franchise requirements. This obligation was expressly made *"a condition upon which the franchise was granted"* and it was *"especially reserved and provided that should the company fail to have said two pipe lines constructed and supplying gas as is herein provided, the city, may upon six months written notice to the company, declare this contract at an end."**

The franchise requirement particularly referred to in Section 23 is set out in Section 22 which imposes on the company the duty to furnish gas *"at all times at a uniform and adequate pressure at the outlet of each customer's meter."* *"From and after the time when the com-*

* Unless otherwise noted italics used in this brief are ours.

*pany is furnishing gas through * * * two pipe lines as provided in Section 23''* (R. 35).

In order to better insure the fulfillment of the above obligation, Section 22 contained special provisions as to pressure gauges, and Section 27 (R. 37) imposed heavy penal obligations and created civil liabilities for the violation of this or any other condition of the contract.

As above stated the ordinance provided the procedure whereby the just and reasonable rates and charges guaranteed under Section 4(A) should be determined. First, the company was to promulgate its rates, Section 4(B). Second, if not satisfied with these rates (and it was known in advance the city would not be, because the parties had not been able to agree on rates), the city was to proceed by complaint before the Railroad Commission as provided by Statute (Kentucky Statutes, 201e-14, Appendix p. 92). Third, if not satisfied with the Commission rates resort could be had to the courts for relief against them, *and for a determination of reasonable rates for the purpose of distributing the impounded fund,* Section 4(E), (R. 32).

The question of temporary rates, and the protection of the mutual rights and equities pending the final fixation of rates by the Commission, or thereafter by the Court, was a matter of prime importance and the method whereby this could be accomplished was provided in Section 4(E) (R. 32). The temporary rates agreed upon were 50 cents per M.c.f. until the company was furnishing gas through two pipe lines as provided in Section 23, and after that 60 cents. Out of each of these rates 10 cents was to be impounded, and remain under the control of the Commission or Court "until the final fixation of just and reasonable rates," by the Commission or Court, after which the funds

so impounded were to be distributed under the orders of the Commission or Court "as the final determination may direct" (R. 33).

The contract further provided in Section 7 (R. 34) that the rates and charges fixed by the Commission (in the event they were accepted as satisfactory) should continue without change for three years after the commission's order. But if the question of rates should be taken to Court, then the "fixation" of rates "by the highest Court to which the same may be taken," should continue as the lawful and contract rates for two years after "the final determination." By virtue of the terms of the Franchise Contract it was essential for the court to determine, first, whether the commission rate was confiscatory, and if found to be so to enjoin its enforcement; second, whether the company rates were reasonable and if found to be so to render judgment ordering the impounded monies paid to the company; third, if the company rates were found to be excessive then *to ascertain and fix reasonable rates and charges* and distribute the impounded money accordingly.

While the parties fully realized that the court could not declare a future rate (that being a legislative function), yet, of necessity, the question of reasonable compensation for a past service was involved in the disposition of the impounded funds and it would be the function of the Court to determine how that should be done. For the period of two years following the final decree, the rate, on the basis of which the impounded money was distributed by the court, would become the agreed or contract rate and not subject to change.

Pursuant to the franchise contract, Section 4(B) (R. 32), the company promulgated its rates on February 26, 1927

(R. 110). The city filed its complaint before the Railroad Commission on March 25, 1927 (R. 109). The temporary rates of 50 cents and 60 cents for gas furnished subsequent to the contract were collected and a custodian was appointed to receive the impounded money (R. 110). Testimony was first introduced before the commission on March 15, 1928 (R. 110), more than a year after the effective date of the franchise contract, and about four months after the company was furnishing gas through the second pipe line (R. 184), at which time the temporary rate went from 50 cents to 60 cents (December 1, 1927).

**5—Company Fulfills Contract Requirement for Second Pipe Line**

Immediately following the making of the franchise contract the company entered into a contract (as contemplated) with Petroleum Exploration (March 24, 1927) for the construction by that company of a second pipe line from Lexington to its gas field in Owsley County, Kentucky (R. 178 to 183). Under that contract the company agreed to purchase a minimum of 750,000,000 cubic feet of gas delivered at Lexington at 40 cents per M.c.f. This line was completed and the appellant began furnishing gas through the same in November, 1927 (R. 184), and on December 1, 1927, the temporary rate of 60 cents went into effect in accordance with Section 4(E) (R. 32). In providing for an increase in the temporary rate to 60 cents after the company should be furnishing gas through two pipe lines it is obvious that the parties did not anticipate a determination by the commission of the reasonableness of the company's rates until after the temporary rate of 60 cents would be in force, and that necessarily the Commis-

sion could not determine just and reasonable rates under the Franchise Contract without taking into consideration and giving effect to the performance by the company of its obligation under Section 23.

**6—Hearings Before Railroad Commission**

Hearings from time to time were had before the commission until June 28, 1929, at which time the case was submitted, and on October 9, 1929 the commission entered its rate order (R. 12). Before the order was entered the company filed its motion requesting the commission to find the various necessary and basic facts of value, etc. (R. 6 to 11), on which it predicated a rate. This motion was overruled, and the Commission refused to make any findings of fact whatever (R. 11).

In its order (R. 12 to 14) the commission specifically recognized that the rate question arose solely under the franchise contract, and declared, (1) that the company's promulgated rates were excessive, (2) that a flat rate of 45 cents was reasonable, and fixed the same as the rate "*from and after* * * * (*the effective date of the franchise contract*) and until such charge or rate may be otherwise fixed by law or by the agreement of parties" (R. 12).

After reciting in clause "Fourth" of the order "that the commission had conformed its procedure as near as might be to the agreements of the said franchise contract" the order stated:

> "That it is provided in Section 4(E) of said franchise contract that pending the final determination of just and reasonable rates and charges by this Commission and including any subsequent proceedings in Court, the defendant company shall have the

right to charge not to exceed sixty (60) cents per thousand cubic feet for its gas; and that in order to afford either side hereto the right, if it be so desired, to proceed in the courts with respect to such fixation of rates, the application of the forty-five cent rate hereby fixed is suspended for a period of thirty (30) days from the entry of this order; that if within said thirty day period either side shall have filed such proceeding in court, then the application of the forty-five cent rate hereby fixed shall be suspended until there be a final fixation in court of said rates and subject to such modification, if any, of said rate as may be fixed by said Court or Courts; but that if no such proceeding be filed in said time, then the said forty-five cent rate shall at once be put into force and effect'' (R. 13).

**7—Proceedings in Court**

Considering itself aggrieved by the commission order and that the 45 cent rate was confiscatory, the company instituted this action on October 19, 1929. A temporary restraining order was granted against the enforcement of the rate and also of the provision in Clause Fifth (b) requiring the company to file the statement therein mentioned (R. 42).

The bill of complaint made the usual and necessary allegations showing threatened confiscation and irreparable injury, alleged that the distribution system in the City of Lexington (leased to the company by the Lexington Utilities Company) should be treated as part of the rate base in determining reasonable rates, that any rates less than those promulgated by the company would be confiscatory, and prayed for a temporary and permanent injunction against the enforcement of the 45 cent rate, and that the

court adjudge the impounded funds to belong to the company (R. 29).

The defendants moved to dismiss for want of jurisdiction or equity in the bill of complaint, and pleaded to the merits (R. 44 to 58).

The case was heard on the motion for a temporary injunction and the motion to dismiss, and the court handed down an opinion on January 28, 1930, 37 F. (2d) 938, overruling the motion to dismiss, granting a temporary injunction against the order requiring the company to file the statement above referred to, and refusing to grant a temporary injunction against the enforcement of the rate on the ground that the commission had expressly suspended the order pending proceedings in court (R. 74 to 77).

On March 24, 1930, the cause was submitted on the record made, evidence taken, and briefs filed before the commission (R. 77). On July 21, 1930, an order was entered filing in triplicate (one set for each member of the Court) complete certified copies of the Commission record, testimony, exhibits and briefs, the order setting forth the same in detail (R. 77 to 82).

This detailed statement of exhibits discloses the scope of the testimony covering the company's property, estimates of reproduction cost new less deterioration, operating results over a period of years and under the temporary rate of 50 cents, estimated return under the company's promulgated schedule of rates, maps, copies of pertinent contracts, etc. The testimony of the witnesses comprised eight typewritten volumes. The record was quite voluminous, rendering difficult a complete and accurate comprehension of the details, particularly by a court which had not seen or heard the witnesses (and which did not have

the benefit of a Master's report), which may to some extent account for a misunderstanding of the court which will be pointed out later.

The above detailed statement of the exhibits (R. 77 to 82) shows that for the purpose of this case all of the appraisal witnesses selected as the valuation date December 31, 1926 (Opinion, R. 83), that date having by common consent been mutually adopted because of its proximity to and substantial identity with the effective date of the franchise contract (February 25, 1927), and because there was no change in the property or its value between the two dates. The ultimate question was the determination of just rates for the service furnished under and pursuant to the terms of the Franchise Contract, and it was therefore necessary to determine the rate base as of the date of that contract. These appraisals were brought forward to December 31, 1927 by the witnesses for both parties, but the difference in property value was unimportant.

As furnishing an additional measure or basis for valuing the company's property the city introduced testimony showing the acquisition of the appellant's capital stock by Columbia Gas & Electric Corporation on January 1, 1928 by an exchange of the latter's preferred stock (which had a market value of $2,880,000.00) for the capital stock of the appellant. The court adopted the market value of such preferred stock as the best evidence of the actual value of the company's property and related such value back to December 31, 1926. The court allocated to the Lexington district on the basis of gas sales a value of $1,586,880.

The court found that the Lexington distribution plant, valued at $611,227.00 (leased from the Lexington Utilities Company), should be treated as part of the rate base, and

fixed the sum of the value of the company's property allocated to the Lexington district ($1,586,880.00), and the value of the Lexington distribution system ($611,227.00), amounting to $2,198,107.00, as the rate base (R. 84). No complaint is made of this finding.

The court fixed allowances for amortization and extraordinary maintenance, and refused to make any allowance for contingencies (R. 87, 88). No complaint is made by appellant of these findings.

At the hearing before the commission on March 14, 1928, and April 26, 1928, the appellant presented testimony in Exhibit form reflecting actual operating results under different rates for the years 1922 to 1927, inclusive, and an estimate of return under the company's promulgated rates.

In its opinion the court discussed at some length the figures reflecting the actual operating results for the years 1922 to 1927, inclusive, and also referred to the Kimball estimate of return under the company's promulgated rates. The actual results in 1927 under the temporary rate of 50 cents (60 cents in December), after applying the court's allowances for amortization and extraordinary maintenance, were considered by the court to fairly represent a "minimum return during a normal year by the application of a 50 cent rate," and that such rate would produce "a return of substantially 7% (found by it to be reasonable) on the valuation of $2,198,107" (R. 89). Appellant complains of this conclusion.

The Court failed to grasp the fact that the 1927 operations did not reflect the minimum annual cost of the gas required to be purchased under the Petroleum Exploration contract amounting to $300,000, as delivery of gas under

this contract did not begin until in November of 1927 and the cost of this gas actually delivered in that year was only $47,485.34 (company Exhibit No. 8, p. 14, column 5, R. 165). It was therefore clear that the operating results in 1927 under the temporary 50 cent rate (60 cents in December) did not furnish an accurate basis for testing the sufficiency of the 50¢ rate. The appellant filed its petition for correction (modification) in which the attention of the Court was called to this obvious error. The court overruled this petition in its order entered July 29, 1932 (R. 90). The insufficiency of the reasons given by the court for this action are discussed later in this brief.

Thereafter appellant filed its motion for special findings of fact and conclusions of law (R. 91 to 97). This motion was overruled (R. 98), which ruling is complained of as to certain facts and conclusions of law thereon.

On September 22, 1932, the court entered its decree (R. 98 to 101), refusing to grant a permanent injunction against the commission rate of 45 cents although finding same to be confiscatory, on the ground that the company had declined to accept the court rate of 50 cents as reasonable, and request a distribution of the impounded funds on that basis.

The petition for appeal, together with the company's assignment of errors was filed and allowed on December 20, 1932 (R. 102 to 108).

## SPECIFICATION OF ERRORS INTENDED TO BE URGED, AND SUMMARY OF ARGUMENT THEREON

### I

Error VII, Point III; Error XI, Point IV; Error IV, Point II; Error IX, Point I

**In determining the Company's net income no allowance was made for the Annual Cost ($300,000) of the Gas purchased from Petroleum Exploration under the contract made for the purpose of complying with Section 23 of the Franchise Contract (requiring the Company to furnish gas through two Pipe Lines)**

The city admitted the necessity of allowing for the cost of this gas in operating expenses after such cost began on December 1, 1927. There was no controversy between the appellant and the city on this point. Therefore, it was not open to the court to disregard such expense. This error of the court was due at first to an oversight. It refused to make any correction on the ground that delivery of this gas did not begin until in November, 1927, and that "the parties" had requested the court to determine the value of the rate base properties as of December 31, 1926, and it was therefore necessary to determine net income as of that date. Further, that it would be necessary to redetermine the rate base as of a subsequent date if any effect was to be given to a change in operating conditions occurring at a later date.

The "request of the parties" to determine property values as of December 31, 1926, was because that date had been selected by the valuation witnesses as equivalent to

the Franchise Contract date, February 25, 1927, as of which time it was absolutely necessary to determine the rate base because the rate question under the contract began as of that date; and as of which date and for the same reason it was necessary to determine net income in testing the validity of the commission rate. But it was equally necessary to determine the validity of the commission rate over the period to which the commission had applied it, to-wit: From February 25, 1927, the date of the franchise contract to the date of the commission's order, October 9, 1929. During that period there was no substantial change in the value of the property (the parties intending that the value as of December 31, 1926 should be adopted for all purposes) but there was a substantial change in operating conditions caused by the increased cost of gas under the Petroleum Exploration contract which began on December 1, 1927, and simultaneously therewith and because thereof the temporary rate of 50 cents went to 60 cents.

While the court indicated an intention to adhere literally to the date, December 31, 1926, for all purposes, yet in ordering a distribution of the impounded funds the court by necessary implication applied its rate base over the entire collection period and found the commission rate confiscatory over tnat period. If such is the proper construction to be placed on the court's findings and decree then appellant does not insist on the error assigned to the failure of the court specifically to apply the rate base over the period of the rate order, or to find the commission rate confiscatory over that period. The fundamental error was in not determining what rate would be reasonable from and after the cost of the Petroleum Exploration gas began on December 1, 1927 (as of which date the agreed temporary

rate of 60 cents went into effect) to the date of the commission order, October 9, 1929.

## II

Error XII, Point VII

### A 50-cent rate for gas would not produce a 7 per cent Return on the Rate Base

In concluding that a 50 cent rate would yield a 7 per cent return based on the 1927 actual operations the court did not make the adjustments necessary in order to test the sufficiency of the 50 cent rate. These adjustments involved first, the quantity of gas sold in a normal year, a temperature correction; second, the quantity and cost of the gas to be purchased including the cost of the Petroleum Exploration gas; third, income tax. Allowing for these necessary adjustments the net income under a 50 cent rate would produce a return of only 2.6%.

## III

Errors VIII, XV, XVI; Points V, IX

### The Company's Promulgated Rates are just and Reasonable

The Franchise Contract and the Statutes under which this rate proceeding was had, provide that the company shall promulgate the rates it proposes to charge. The only limitation placed upon this right and duty is that the rates be just and reasonable. If the promulgated rates be within that limitation neither the Commission nor Court had any right to change them. The promulgated rates are in proper form, are just and reasonable, and will produce a return of only 5.42% on the rate base fixed by the court.

## IV

Error XIII, Point VIII

### A 7 per cent return is not fair and reasonable

This case involves rates for natural gas. By the uncontradicted testimony it is shown that the company is entitled to a 10 per cent return. From the nature and character of the commodity supplied an extra hazard is involved in the business of producing and distributing natural gas, and the rate of return should be higher than in the case of ordinary utilities involving no such risk.

## V

Error XVII; Point XI

**The Court should have granted a permanent injunction against the commission rate**

Having found the commission rate confiscatory, the court should have granted a permanent injunction against its enforcement. The refusal of the court to do so unless the company accepted a 50-cent rate and surrendered its statutory right of appeal is not justified by the equitable maxim that "He who seeks equity must do equity." This maxim has no application because the parties themselves by contract have defined their rights pending the final determination of just and reasonable rates. The contract was inherently equitable in its provisions for the protection of both parties and the commission rate being held confiscatory, the company is entitled, as proper equitable relief, to have a permanent injunction granted. Its right of appeal need not be sacrificed. The condition imposed by the court below was unwarranted.

## VI

Error XVIII; Point XII

**The Costs should not have been assessed against the Company**

As the parties had agreed in the franchise contract to pay all court costs arising out of this rate proceeding equally, it was error to order the company to pay the costs.

# ARGUMENT

## The failure of the Court to give proper effect to the Cost of Gas under the Petroleum Exploration Contract constitutes the main error

Errors III, IV, V, VI, VII, IX, X, XI; Points I, II, III, IV (R. 247-249) (R. 103 to 106); Motion for Findings of Fact, paragraph 3 (R. 92), paragraph 4 (R. 93), paragraph 7 (R. 94), and Conclusions of Law, paragraphs 1 and 2 (R. 95), paragraphs 5 and 6 (R. 95, 96).

### (a) The Issue Stated and Facts to be Determined

At the outset it is essential to state the precise issue presented to the court below for its decision and of which it took jurisdiction. The issue is clearly stated in the earlier opinion of the Statutory Court on the question of jurisdiction, 37 F. (2d.) 938. It said:

> "The plaintiff * * *, is engaged in the sale and distribution of natural gas in the City of Lexington, Kentucky, *under a franchise granted to it by the City* on February 25, 1927, * * * (which) *does not fix the rate to be charged for such service.*"

The Court then quotes in full Sections 4 (A), (B), (C), (D), (E) and (F) (R. 32 to 34) of the Franchise Contract prescribing the method for determining the "rate to be charged."

The Court further stated:

> "The bill discloses that, in compliance with Section 4 (B), the plaintiff, within two days after *the effective date of its franchise,* promulgated * * * the

rates proposed to be charged by it *in rendering the service contemplated in the franchise,* and that * * * City of Lexington and S. B. Featherston, * * * filed a complaint with the Railroad Commission, attacking the rates * * * as excessive * * * and asking that the Commission fix just and reasonable rates * * *; a hearing was had and *on October 9, 1929* the *Commission entered an order* holding that the rates proposed * * * were unreasonable * * * and fixing forty-five cents (per M. c. f.) * * * as the lawful rate to be charged * * *. *The order further provides that the rate thus fixed should be effective from January 28, 1927, which date is declared by the order to be the effective date of the franchise.*"

It is thus clear that the lower court understood that the commission had declared a rate for "*the service contemplated in the franchise*" and that such rate should be the lawful rate from "*the effective date of the franchise*" and *for the period from and after that date to the date of the commission order.* The commission named January 28, 1927 as the contract date. This was error—that was the date on which the franchise ordinance was adopted. The "effective date" of the contract was February 25, 1927.

The opinion then quotes paragraphs Fourth and Fifth of the commission order in which it is recited:

> "That the Central Kentucky Natural Gas Company filed herein, at the inception *of this* * * * *controversy,* a copy of *its ordinance-franchise whereunder it is operating* in the City of Lexington; *that said franchise-contract made certain stipulations* * * * *about the fixation of rates under it,* and that the Commission had (has) conformed its procedure as near as might be *to the agreements of said franchise-contract* * * *; that * * * the application of the forty-

five cent rate hereby fixed shall be suspended until there be a final fixation in court of said rates * * *.

That * * * said forty-five cent rate * * * as modified by the court, shall be effective from said 28th day of January, 1927.

Fifth. That * * * there have been impounded under the control * * * of the Commission, *as provided in * * * said franchise,* considerable sums * * * under the temporary rates * * * which * * * are to be distributed * * * under the orders of the courts to which *this controversy* may be taken * * *."

It thus appears that the court below clearly understood that *"this controversy"* over rates arose *under the franchise-contract,* and that the first and essential inquiry was whether the commission rate was valid or confiscatory "from and after * * *" (*the effective date of said franchise*) to the date of said order (Commission Order, clause second, R. 12), and that the second inquiry would be (if the commission rate should be found confiscatory *for such period*), what are the just and reasonable rates guaranteed under Section 4 (A), *"in rendering the service contemplated in the franchise"* (R. 32).

While the Commission had refused to find any facts as to value, net income or return, and merely fixed a 45¢ rate as the lawful rate *"in rendering the service contemplated in the franchise,"* the presumption is that the commission did find some value for the company's property, did estimate some net income, and did have in mind some rate of return. As the rate of 45 cents was made continuous over the period from the effective date of the franchise contract to the date of the rate order it must be further presumed that the commission intended to adopt the same rate base for that period.

As stated above an agreed order was entered (R. 77) submitting the issues presented by the pleadings on the evidence introduced before the Commission (as sufficient for the determination of all questions). On that evidence and under such issues the ultimate questions of fact presented to the court for decision were:

(1) The value of the rate base properties *as of the contract date, and for the period from that date to the date of the commission order*

(2) The fair rate of return for the same period

(3) The allowance for amortization, extraordinary maintenance, and contingencies

(4) The actual net income available for return under the temporary rates, as bearing on the validity of the commission rate and the reasonableness of the company's promulgated rates

(5) The probable net income under the commission rate, and whether that rate was confiscatory

(6) The probable net income under the appellant's promulgated rates, and if those rates appeared excessive, then

(7) Such rates for *"the service contemplated in the franchise"* for the period in question as would yield net income sufficient to earn a fair return on the rate base after making proper allowances for amortization, etc.

**(b) How the Court Determined the Rate Base**

It now becomes essential to state the substance of the testimony relating to property value and net income available for return. The record shows that the parties had by common consent adopted December 31, 1926 as the con-

venient and logical date for determining the value of the appellant's property used and useful "in rendering the service contemplated in the franchise." The two expert witnesses who testified to values, based on reproduction cost new less deterioration (Kimball for the company, and Carter for the city), made their appraisals on the basis of price levels as of December 31, 1926, which date was only a few weeks prior to the contract date and therefore equivalent to that date (and was so treated by the parties). These witnesses brought up their appraisals to December 31, 1927, by including the cost of net additions made during 1927. The difference (increase) was not material (R. 111, 185, 186).

Mr. Jirgal for the city testified and filed exhibits showing historic cost as of December 31, 1926, and as of December 31, 1927 (R. 185). He also estimated the reproduction cost as of December 31, 1926, and as of December 31, 1927.

There was no other testimony on values, and no evidence of any change in price levels or trends between December 31, 1926, and the date of the commission order, October 9, 1929. It thus appeared that the fair value of the company's property determined as of December 31, 1926, would necessarily be its fair value as of the franchise-contract date, and for the period from and after that date to the date of the commission's order.

As bearing on the question of value, the city also introduced testimony of the exchange by Columbia Gas & Electric Corporation of its preferred stock for the capital stock of the appellant (R. 207 to 212), the market value of the Columbia preferred stock so issued being $2,880,000 (Opinion, R. 83). This exchange or purchase took place as of January 1, 1928.

The court below after considering all the testimony bearing on the value of the property adopted as the best evidence of such value the exchange value or purchase price of appellant's capital stock (Opinion, R. 83). This value, thus established as of January 1, 1928, the court adopted as the value of appellant's property on December 31, 1926. Such value should properly have been applied to the franchise contract date because the question of value arose only under the contract, but the application of such value to December 31, 1926, may be treated as equivalent to the contract date. As already stated, no complaint is here made of the rate base as fixed by the court.

**(c) In Determining Net Income the Court Overlooked the Cost of the Petroleum Exploration Gas**

The court considered and discussed in detail the evidence presented in company Exhibit No. 4 (R. 112 to 120) reflecting the actual operating results under a 40¢ rate during the years 1922 to 1926, inclusive, and also reflecting the actual operating results in 1926 under the temporary rate then in force (prior to the franchise contract). The court also considered and discussed at some length the actual operating results in 1927 under the temporary rate of 50 cents (60 cents in December) presented in complete detail in company Exhibit No. 8 (R. 152 to 167). The court therefore considered the actual operating results under different rates both before and after the franchise contract, and adopted the experience figures for 1927 (covering a full year after December 31, 1926) as the basis of its conclusion that a 50¢ rate would earn a 7 per cent return on its rate base.

It is thus apparent that the court was in fact attempting to find a rate for gas that would be fair to the company *"in rendering the service contemplated in the franchise,"* and was not endeavoring to determine merely what rate would be fair as of a static date, December 31, 1926, or under the precise operating conditions existing on said date, which was prior to the franchise contract and the period over which just rates were to be determined.

In addition to the actual operating results fully set forth in company Exhibit No. 4 for the years 1922 to 1926, inclusive, and in company Exhibit No. 8 for 1927, Mr. Kimball presented his estimate of net income under the company's promulgated rates in company Exhibit No. 6 (R. 131 to 145).

In this connection we again mention the obligation of the company to furnish gas through an *additional* pipe line to adequate fields of supply (Section 23, R 36) and the subsequent performance of that duty by the company in entering into a contract with Petroleum Exploration for the delivery of gas to the appellant through a second pipe line from Lexington to the gas fields of said company in Owsley County, Kentucky, under which contract the appellant agreed to purchase an annual minimum of 750,000,000 cubic feet of gas at 40 cents per M.c.f. The appellant began furnishing gas through this second pipe line in November, 1927, and by reason thereof the temporary rate went from 50 cents to 60 cents on December 1, 1927, as provided in Section 4(E) of the Franchise Contract (R. 32).

As appears in company Exhibit No. 8, page 14 (R. 165), the Petroleum Exploration delivered to the appellant in 1927, 118,713 M.c.f. of gas, and that the appellant paid for this gas at 40 cents per M.c.f. the sum of $47,485.34. But

the minimum annual cost of gas under this contract would be $300,000.00. Therefore only a small part of such annual cost appeared in the 1927 figures.

The accuracy of the figures set forth in company Exhibit No. 8 showing in detail the actual operating results in 1927 under the temporary rate of 50 cents (60 cents in December) has never been questioned. The court below accepted them and in so doing necessarily recognized and sustained the validity of all of the gas purchase contracts, including the Petroleum Exploration contract, as listed in company Exhibit No. 8, page 14 (R. 165), wherein is set forth the name of each company from which gas was purchased, the quantity purchased, the price and amount paid.

This exhibit shows a net income of $98,307 after deducting the company's allowances for amortization, extraordinary maintenance and contingencies amounting to $121,530 for the Lexington district (company Exhibit 8, p. 5, R. 153-154). The court found these allowances excessive in the amount of $46,267, which it said should be added to the aforesaid net income of $98,307, thus making the court finding of net income available for return in 1927 under the temporary rate of 50 cents (60 cents in December) the sum of $144,574 (R. 89). The court then said:

> "This result may be reasonably accepted, it seems to us, as a fair prophecy of a minimum return during a normal year by the application of a 50 cent rate" (R. 89).

The court's prophecy was thus rested on the actual 1927 operations. But the court overlooked the fact that the actual operations in 1927 did not reflect the entire annual cost of gas under the Petroleum Exploration con-

tract, and therefore that the net income under the operating results in 1927 under the 50 cent temporary rate (60 cents in December) could not be adopted as representing the net income that would be earned in a normal year under a 50 cent rate after making full allowance for the annual cost of gas under the Petroleum Exploration contract.

**(d) The Court's Refusal to Make Correction for the Petroleum Exploration Gas and Its Reasons Therefor Examined**

Conceiving that the court had merely made an obvious "slip" the appellant filed a petition for correction (modification). This petition was overruled, the court saying in its order (R. 90):

> "*Upon the hearing of this cause the parties requested the Court to fix the base value* of plaintiff's property allocable to Lexington *as of December 31, 1926, and determine whether the rates established by the Commission* afforded a reasonable return on such value *as of said date.* The Court having acted upon such request and made its findings and determinations *as of said date,* the plaintiff now asks the Court to make further findings and determinations based upon its contract with the Petroleum Exploration. Plaintiff did not begin to take gas under this contract until November of 1927, *and it appearing,* therefore, *that there can be no determination of the effect of such contract* upon the reasonableness of the order of the Railroad Commission *without a redetermination of the base value* as of a date subsequent to that adopted and used by the Court at the request of the parties *and a reconsideration of what would be a reasonable rate under changed conditions,* if any: IT IS ORDERED * * *."

Let us analyze the foregoing statements and conclusion. The court says:

(1) The parties requested the court to fix the rate base as of December 31, 1926.

If the court had said that the parties had requested it to ascertain and determine the base value as of December 31, 1926, and to "*fix*" and adopt such value as of the franchise contract date, February 25, 1927, and thereafter for all purposes of this case, its statement would have been accurate. To fix the value as of December 31, 1926 would be a vain thing unless such value was applied to the contract and adopted as the base value for determining the reasonableness of any rate "*in rendering the service contemplated in the franchise*" (Opinion 37 F. (2d) 938, 941).

The court then says:

(2) The parties asked the Court to determine the reasonableness of the Commission rate on the base value as of December 31, 1926.

In view of the fact that the commission applied its rate to the "effective date of the contract," it would have been absurd for the parties to ask the court to determine the reasonableness of the commission rate as of any date prior to the contract, when the commission itself had not so applied it, and when the validity of such rate as of that date was not and could not be an issue in the case. The parties did ask the court to adopt the base value as of December 31, 1926 for the purposes of "this controversy" (being the determination of reasonable rates *under* the franchise contract and not *outside* the contract); and for the purpose of testing the validity of the commission rate

as of the contract date and thereafter to the date of the rate order, because that was the period to which the commission had itself applied the rate, and therefore the validity of such rate was attacked and under inquiry for that period, and not merely as of the contract date. The issues are made by the pleadings, and not by alleged requests. However, the court was never requested at any time by any of the parties to determine the validity of the commission rate as of December 31, 1926, and there is absolutely nothing in the record to support such statement.

The court further says:

> (3) The Court having acted upon such request, the plaintiff now asks the Court to make findings based on its contract with the Petroleum Exploration.

From the very inception of "this controversy" and as a necessary finding of fact to be made the plaintiff had at all times insisted on its right to have a reasonable rate under the franchise contract, and in accordance with the fulfillment by it of the obligation imposed by Section 23 (R. 36), to wit, the making of the Petroleum Exploration contract to secure the additional supply of gas. The cost of gas purchased under this contract in December, 1927, appeared in the company's operating statement introduced in evidence. The contract was filed in the record. The city expressly admitted the right of the appellant to an allowance for the cost of gas under this contract. There was no dispute with the city on this point. It was not open to the court in estimating what the company would earn under a 50 cent rate, or under any other rate, to exclude from operating expenses an item of $300,000.00 per annum which was conceded by the city.

The appellant by its petition for modification did not ask the court to make "further" findings. It asked the court to make the findings it should have made and was asked to make when the case was submitted, findings that were absolutely essential to a proper decision. It was because of the Petroleum Exploration contract and the additional expense thereunder that the parties had stipulated in the franchise contract that the temporary rate of 50 cents should be increased to 60 cents as soon as gas was being furnished through the second pipe line. On its face and by the express terms of the contract the city had agreed that the company would be entitled to a higher rate for its service after the additional cost began under its contemplated contract with Petroleum Exploration and it was furnishing gas through the second pipe line. The appellant insists it would have been preposterous for it to request or consent to any determinations that involved the exclusion of the cost of gas under the Petroleum Exploration contract in determining the validity of the commission rate, and that a determination of the rate base "at the request of the parties" as of December 31, 1926 did not involve the perpetration of any such absurdity.

The court further says:

> (4) The plaintiff did not begin to take gas under this contract (Petroleum Exploration) until November of 1927.

This is true, but appellant's obligation to secure this gas was created by the franchise contract, arose upon the execution of that contract, and was *"the condition"* on which the franchise was granted. The fact that actual delivery of gas under this contract, or that the furnishing

of gas through the second pipe line as required under Section 23 (R. 36) did not commence until December 1, 1927, was no reason why the cost of such gas should not be allowed in determining reasonable rates under the franchise contract *"in rendering the service contemplated in the franchise"* (37 F. (2d.) 938, 941). The phrase quoted is the language of the court. What was the *"service contemplated in the franchise"?* Primarily and essentially the furnishing of gas *through two pipe lines* (Section 23, R. 36), and *"at all times at a uniform and adequate pressure at the outlet of each customer's meter"* (Section 22, R. 35).

The contract with Petroleum Exploration was to enable appellant to render this high standard of service, and the making of such contract was accepted by the city as a fulfillment by the appellant of the obligation imposed by Section 23 as *"the condition of the franchise grant."* In all frankness we submit that the effort of the court below to place on "the parties" the blame for its obvious oversight is wholly unwarranted. The appellant insists that the court was in error in characterizing its request to correct a clear oversight as a request "to make *further* findings" or that such application was inconsistent with the request of "the parties" to determine the base value as of December 31, 1926 and to adopt such value for "this controversy."

The court further says in its order:

> (5) There can be no determination of the effect of the Petroleum Exploration contract upon the reasonableness of the Commission rate without a redetermination of the base value as of a date subsequent to December 31, 1926.

The foregoing statement or conclusion is a *non-sequitur*. The Petroleum Exploration contract affects operating expenses and net income, neither of which have any relation to base value as of any date. The rate base may remain constant while net income may vary with changes in operating conditions, and *vice versa*. Furthermore, the evidence showed without contradiction that there was no substantial change in the value of the property during the period between December 31, 1926 (or the franchise contract date, February 25, 1927) and the date of the rate order. The court had already established the rate base as of January 1, 1928, in taking the market value as of that date of the preferred stock of the Columbia company issued in exchange for the capital stock of the appellant. It merely applied this value to December 31, 1926. The value thus determined as of January 1, 1928, was obviously the same as it was thirty days prior thereto (December 1, 1927, when the temporary rate of 60 cents went into effect), and a "redetermination of the base value as of a date subsequent" was wholly unnecessary because this had in fact been done by the court. And, finally, in ordering a distribution of the impounded funds on the basis of a 50-cent rate being reasonable, the court has by necessary implication adopted and applied such rate base for the period of the impoundment, and has found the commission rate of 45 cents invalid over the same period.

**(e) The Court Did Not Understand the Company's Estimate of Net Revenue Under the Promulgated Rates**

We have heretofore mentioned the fact that Mr. Kimball had presented an estimate of return under the company's promulgated rates. The supporting figures were

carefully worked out in complete detail in company Exhibit No. 6 (R. 131 to 145). In rejecting this estimate the court said (Opinion, R. 86-87):

> "Plaintiff also makes an estimate of what income would be produced in a normal year by applying the first schedule of 60 cents, which was promulgated in accordance with the ordinance and which was reviewed and held exorbitant by the Railroad Commission. While plaintiff shows a total revenue of $701,276 under such schedule *yet strange as it may seem,* by some process of reasoning it shows a net operating revenue before the deduction of taxes, etc., on the *60* cent rate of *less* than was actually received in 1927 by the application of a *50* cent rate for eleven months and a 60 cent rate for one month. *It is equally strange* that plaintiff shows a net income available for interest and dividends under the first schedule for an assumed normal year of only *$73,013,* as against *$98,307* for the year 1927, where a *50* cent rate was applied for eleven months of the year and a 60 cent rate for only one month. *We cannot accept the soundness of any such figures.*"

The criticism shows conclusively that the court did not understand the Exhibit nor Mr. Kimball's testimony directed thereto. The reason why a less net return was shown by Mr. Kimball under the company rates (averaging 60 cents) than under the temporary rate of 50 cents, notwithstanding the increased gross revenue produced thereby, were in the main two-fold: First, the greatly increased cost of gas caused by the contract made with Petroleum Exploration in compliance with Section 23 of the Franchise (R. 36); second, the decreased consumption caused by the higher rate. (company Exhibit No. 6, p. 11, R. 139).

**(f) The Cost of the Petroleum Exploration Gas Must Be Allowed in Operating Expenses**

The refusal of the lower court to revise its estimate of the sufficiency of a 50 cent rate for gas so as to give proper and full effect to the cost of the Petroleum Exploration gas constitutes the principal error urged in this appeal.

The question is thus squarely presented as to whether in any estimate of net income as for a normal year for the purpose of testing the validity of the commission rate of 45 cents, or the sufficiency of the court rate of 50 cents, or the reasonableness of the company's promulgated rates, allowance must be made in operating expenses for the minimum cost of the Petroleum Exploration gas delivered through the second pipe line. The record permits but one answer.

The pivotal and essential consideration for the franchise contract, indeed the prime inducement to the city for granting the franchise, was the definite obligation of the company to improve its service by furnishing gas through an additional pipe line built to an adequate source of supply in Kentucky or West Virginia (Section 23, R. 36). The agreement to do this was made the *"condition upon which the franchise is granted."* Failure to fulfill such *"condition"* within the time limited gave the city the right to *"declare this contract at an end"* (R. 36, 37).

The necessity for and importance of this additional pipe line appears in Section 22 of the Franchise Contract (R. 35) which in terms postponed the obligation to furnish gas *"at all times at a uniform and adequate pressure"* until: *"From and after the time when the Company is furnishing gas through * * * two pipe lines."*

That the gas service would be worth more (as well as cost more) after gas was being furnished through two pipe lines was expressly recognized in the contract by providing for an increase in the temporary rate from 50 cents to 60 cents "after it (the company) is furnishing gas through * * * two pipe lines," Section 4(E) (R. 32). There was no difference of opinion between the company and the city on this matter. This conclusively appears from the record. The filing of a copy of the contract with Petroleum Exploration was requested by the city (R. 173). The only estimates of net income offered by the city, based on 1926 sales, made an allowance in operating expenses for 750,000 M.c.f. of gas as the annual minimum agreed to be purchased from Petroleum Exploration at 40 cents per M.c.f. (Carter Exhibit 8, Sheet B, Sheet 2, R. 190, and Carter Exhibit 10, R. 192). The Company's fixed obligation to purchase this gas and to pay annually the sum of $300,000.00 was expressly conceded and stated by counsel for the city and testified to by Mr. Carter (R. 186 to 190). In fact, this was the one gas purchase contract which the city admitted to be a definite and fixed obligation of the company (Carter Exhibit 8, R. 190-191), and is the only contract which the court refused to give effect to.

Appellant contends that under this state of the record it was not open to the court to reject in whole or in part as an operating expense an item of cost thus conclusively established by the proof, and expressly admitted by the city.

**(g) The Sufficiency of the 50 Cent Rate Prior to December 1, 1927, and Before the Company Began Furnishing Gas Through Two Pipe Lines Is a Moot Question**

It is of course obvious that until the cost of gas under the Petroleum Exploration contract actually became an operating expense, to-wit, December 1, 1927, when the second temporary rate of 60 cents went into effect, no allowance could be made therefor in determining net income from the contract date, February 25, 1927, until December 1, 1927, a period of nine months. The validity of the commission rate of 45 cents and the sufficiency of the court rate of 50 cents for that period must be determined on the basis of the gas purchase contracts existing as of the Franchise date, and without regard to the cost of gas under the Petroleum Exploration contract. It was actually on this basis that the court below found the commission rate invalid and confiscatory. It was on the same basis that the court based its "prophecy" that a 50 cent rate would earn a 7 per cent return on the rate base. Later in this brief we demonstrate that a 50 cent rate (excluding the Petroleum Exploration gas) would not in fact produce a 7 per cent return on the court's base value, and that such rate after making the proper adjustments would in fact produce a return of only 6.3 per cent on such value.

But whether a 50 cent rate would be adequate for the period from the contract date to December 1, 1927, when the second temporary rate of 60 cents went into effect on account of the Petroleum Exploration gas, is really a moot question because for that period the temporary rate collected was only 50 cents. Therefore, even if the company were entitled to a higher rate for that period it would now be impossible for it to collect more than the temporary

rate. Furthermore, it might perhaps be fairly contended that the company in agreeing to the temporary rate of 50 cents for that period impliedly consented to be satisfied with that rate even if the commission or court should find that it was entitled to a higher rate. The appellant is not disposed to insist on a contrary view.

It is therefore only necessary for this Court to determine whether the appellant is entitled to a higher rate than 50 cents after the cost of the Petroleum Exploration gas began, and the 60 cent temporary rate went into effect. Later in this brief we demonstrate that under the company's promulgated rates (averaging 60 cents) it would earn less than a 6 per cent return on the court's rate base.

**(h) While the Court Should Have Specifically Applied Its Findings of Fact to the Contract Date and to the Period of the Rate Order This Was in Fact Done by Necessary Implication**

Subsequent to the lower court's action in refusing to give effect to the full annual expense of gas under the Petroleum Exploration contract the appellant filed a motion for special findings of fact and statement of conclusions of law thereon, thus presenting the theory of the appellant both as to the facts and the law. This motion was overruled without comment other than to state that the court considered its findings of fact and statement of its conclusions of law thereon sufficiently set forth in its opinion.

We have already discussed the Points made and the Errors assigned relating to the Petroleum Exploration contract. It remains to consider the court's refusal in express terms to apply the facts found to the contract date, and specifically to determine the validity of the commission's

rate over the period to which the commission itself had applied that rate.

The court in its opinion and decree relates all of its findings of fact to December 31, 1926. However, the court in finding that a 50 cent rate would be reasonable actually applies that rate to the period over which the money has been impounded out of the temporary rates and thus by necessary implication actually applies the rate base to the same period. It holds the commission rate to be invalid and confiscatory over the same period.

Merely because the parties requested the court to determine the value of the property as of December 31, 1926, to which the evidence on reproduction cost new less deterioration was directed, creates no magic about that date. The question of value and all other questions arise under the contract and cannot be determined by conditions existing prior to its effective date. The value date was selected by the parties solely as a matter of convenience, and because of its immediate proximity to the franchise contract date. There was no difference in value or net income as between these two dates.

The court's error in making its findings as of December 31, 1926 instead of for the period of the rate order may be treated as technical, rather than substantial. It would appear that while the court has refused to do this in terms it has done so by necessary implication in directing a distribution of the fund impounded under the contract on the basis of a 50 cent rate as reasonable, an order inconsistent with any view other than that the court intended to apply its base value to that period and to hold the commission rate confiscatory over such period. If that shall be the view of this Court then the errors assigned

based on the lower court's refusal specifically to apply its findings to the period of the impoundment may be disregarded.

That would leave under this branch of the argument only the court's error in refusing to make the proper allowance for the cost of gas under the Petroleum Exploration contract. As will be discussed later in this brief the appellant contends that on the undisputed facts of this record this Court should find its promulgated rates are in fact just and reasonable, that lower rates would be confiscatory, and direct the entry of a decree sustaining said rates.

## A 50-cent rate for Gas would not produce a 7 per cent Return on the Rate Base

(Error XII, Point VII)

As the basis for the conclusion that "a 50 cent rate may be reasonably expected to earn" a 7 per cent return, the court used the operating results in 1927 under the temporary rate of 50 cents (60 cents for the month of December) set out in Company Exhibit No. 8. The court failed, however, to make certain necessary adjustments of the 1927 figures before it could properly determine whether a 50 cent rate would in fact produce in a *normal* year a net income sufficient to make a 7 per cent return on the rate base. This can be readily demonstrated. For that purpose we submit the computations shown in the tabular statements following. Including the cost of the Petroleum Exploration gas the 50 cent rate would yield a return of only 2.6 per cent. It is necessary to make only three adjustments,

(1) to show the consumption of gas in a normal year, a temperature correction, 1927 being warmer than usual, and in a normal year the consumption and sales would be greater than they were in 1927, and gross revenue would be correspondingly greater; (2) as more gas would be sold the expense for purchased gas would be increased, and (3) the amount of Federal Income tax would likewise be affected by the difference in net income.

For purposes of comparison Statement No. 1, column 4, also shows estimate of return under the company's promulgated rates which is discussed later in this brief.

## STATEMENT NO. 1

| | 1927 Actual Per Kimball Exhibit No. 8 | 1927 Actual As Allowed by Federal Court | Estimate—Normal Year—1927 Corrected for Deviation from Mean Monthly Temperature including cost of Petroleum Exploration Gas | Return under Promulgated Rates |
|---|---|---|---|---|
| Retail Rate for Gas in Lexington | 50c 1st 11 Mo. 60c—Dec. | 50c 1st 11 Mo. 60c—Dec. | 50c | |
| Income Account Based on Treating Central Ky. Co. and Lexington Utilities Co. as a Unit and Disregarding Rental Payments of Former to Latter: | | | | |
| Revenue— | | | | |
| Gas Sales | $ 606,912 (1) | $ 606,912 (1) | $ 622,784 (8) | $ 691,670 (12) |
| Gasoline, Shop, Interest, Miscellaneous | 5,942 (2) | 5,942 (2) | 5,942 (2) (9) | 9,606 (13) |
| Total | $ 612,854 (1) | $ 612,854 (1) | $ 628,726 | $ 701,276 (13) |
| Operating Expenses— | | | | |
| Field and Main Line Expense | $ 33,024 (1) | $ 33,024 (1) | $ 33,024 (1) (9) | $ 28,464 (13) |
| City Plant Expense exclusive of Rental | 47,681 (1) | 47,681 (1) | 47,681 (1) (9) | 41,946 (13) |
| General Expense | 16,596 (1) | 16,596 (1) | 16,596 (1) (9) | 21,839 (13) |
| Gas Purchased | 269,703 (1) | 269,703 (1) | 360,499 (10) | 379,848 (13) |
| Total | $ 367,004 (1) | $ 367,004 (1) | $ 457,800 | $ 472,097 |
| Net Operating Revenue, etc. (before Taxes) | $ 245,850 (1) | $ 245,850 (1) | $ 170,926 | $ 229,179 |
| Taxes— | | | | |
| Franchise Tax | $ 14,620 (3) | $ 14,620 (3) | $ 14,620 (3) (9) | 14,620 (13) |
| Tangible Property Tax | 6,694 (3) | 6,694 (3) | 6,694 (3) (9) | 6,694 (13) |
| Federal Capital Stock Tax | ..... | ..... | ..... | ..... |
| Miscellaneous Assessments | ..... | ..... | ..... | ..... |
| Federal Income Tax | 4,699 (3) | 4,699 (3) | 17,039 (11) | 13,322 (13) |
| Total | $ 26,013 (3) | $ 26,013 (3) | $ 38,353 | $ 34,636 (13) |
| Net Operating Revenue, etc. (after Taxes) | $ 219,837 (1) | $ 219,837 (1) | $ 132,573 | $ 194,543 |
| Amortization, etc.— | | | | |
| Amortization and Depletion: | | | | |
| Central Ky. Nat. Gas Co. | $ 82,477 (4) | $ 50,000 (7) | $ 50,000 (7) | 50,000 (7) |
| Lexington Utilities Co. | 12,191 (4) | 10,263 (7) | 10,263 (7) | 10,263 (7) |
| Extraordinary Maintenance: | | | | |
| Central Ky. Nat. Gas Co. | 12,878 (4) | 10,000 (7) | 10,000 (7) | 10,000 (7) |
| Lexington Utilities Co. | 8,384 (4) | 5,000 (7) | 5,000 (7) | 5,000 (7) |
| Contingencies—Central Ky. Nat. Gas Co. | 5,600 (4) | ..... (7) | ..... (7) | ..... (7) |
| Total | $ 121,530 (4) | $ 75,263 | $ 75,263 | $ 75,263 |
| Net Income Available for Interest and Dividends | $ 98,307 (5) | $ 144,574 (7) | $ 57,310 | $ 119,280 |
| Investment (Rate Base) | $2,639,296 (6) | $2,198,107 (7) | $2,198,107 (7) | $2,198,107 (7) |
| Return on Investment—Per Cent | 3.7% | 6.6% | 2.6% | 5.42% |

NOTES:
(1) Company Exhibit No. 8, pg. 6, Col. 4 (R. 155)
(2) " " No. 8, " 6, " 4 (R. 155) Sum of Gasoline, Shop, Interest and Misc. Revenue
(3) " " No. 8, " 15, " 4 (R. 167)
(4) " " No. 8, " 16, " 2 (R. 167)
(5) " " No. 8, " 5, " 2 (R. 154)
(6) Opinion R. 83, 84
(7) Opinion R. 82
(8) 1,245,568 M. c. f. (estimated retail sales Lexington District at 50 cent rate—Company Exhibit No. 6, pg. 11, col. 9) x $0.50 (R. 139)
(9) As allowed by implication in decision of Court (see Note 7 above)
(10) See detail sheet (Statement No. 3 attached)
(11) " " " " No. 4 " )
(12) Company Exhibit No. 6, pg. 5, Col. 6 (R. 135)
(13) " " No. 6, " 4, " 2 (R. 134)

## STATEMENT NO. 2

**Estimated Gas Sales (M. c. f.) and Revenue for the Entire System and Portion Allocated to Lexington District, Based on a Retail Rate of 50 cents per M. c. f., Giving Effect to Mean Temperature from 1906 to 1926 inclusive**

| | *Entire System* | | | | *Lexington District* | | |
|---|---|---|---|---|---|---|---|
| | *Total Sales (M. c. f.)* | *Average Rate per M. c. f.* | *Revenue* | *Basis of Allocation* | *Total Sales (M. c. f.)* | *Average Rate per M. c. f.* | *Revenue* |
| **RETAIL SALES** | | | | | | | |
| Lexington District | 1,245,568 (1) | $ .50 | $ 622,784 | Location | 1,245,568 | $ .50 | $ 622,784 |
| Winchester | 268,596 (2) | .50 | 134,298 | " | ..... | .... | ..... |
| Mt. Sterling | 156,432 (2) | .50 | 78,216 | " | ..... | .... | ..... |
| Total Retail Sales | 1,670,596 | | $ 835,298 | | 1,245,568 | | $ 622,784 |
| **WHOLESALE SALES** | | | | | | | |
| Frankfort, Ky. Nat. Gas Co. | 323,932 (2) | $ .35 (3) | $ 113,376 | | ..... | .... | ..... |
| Kentucky Utilities Co. | 180,097 (2) | .375 (4) | 67,536 | | ..... | .... | ..... |
| Blue Grass Nat. Gas Co. | 15,407 (2) | .375 (5) | 5,778 | | ..... | .... | ..... |
| Total Wholesale Sales | 519,436 (2) | | $ 186,690 | | ..... | .... | ..... |
| Total Sales | 2,190,032 | | $1,021,988 | | 1,245,568 | | $ 622,784 |

NOTES: (1) Company Exhibit No. 6, p. 11, Col. 9 (R. 139)
(2) " Exhibit No. 6, p. 12, Col. 3 (R. 140)
(3) " Exhibit No. 6, p. 12, Note A (R. 140)
(4) " Exhibit No. 6, p. 12, Note B (R. 140)
(5) " Exhibit No. 6, p. 12, Note C (R. 140)

## STATEMENT NO. 3

**Estimated Quantity and Cost of Gas Purchased Assuming a Retail Rate of 50c per M. c. f., and Giving Effect to Mean Temperature from 1906 to 1926, Inclusive**

**(A): Giving Effect to Petroleum Exploration Co. Contract (taking minimum allowance only)**

| *Name of Company* | *Minimum Quantity per Contract (M. c f.)* | *Estimated Quantity of Gas Purchased (M. c. f.)* | *Contract Price per M. c. f.* | *Estimated Cost of Gas Purchased* | *Basis of Contract Price per M. c. f.* |
|---|---|---|---|---|---|
| United Fuel Gas Co. | 720,000 (1) | 720,000 (2) | $ 0.25 | $ 180,000 | 50 Per Cent of Average Domestic Rate (6) |
| Petroleum Exploration Co., Inc. | 750,000 (1) | 750,000 (2) | .40 | 300,000 | 40 Cents per M. c. f. at Lexington City Gate (6) |
| Hillsdale Gas Co. | 720,000 (1) | 450,000 (2) | .23⅓ | 105,000 | 20 Cents plus ⅓ of any increase over 40 cents per M. c. f. (6) |
| Bed Rock Petroleum Co. | 1,220,000 (1) | 125,000 (2) | .15 | 18,750 | 30 Per Cent of Average Domestic Rate (6) |
| Carroll Oil and Gas Co. | 300,000 (1) | 200,000 (2) | .10 | 20,000 | 10 Cents per M. c. f. (6) |
| Kentucky Cities Gas Co. | 1,000,000 (1) | 125,000 (2) | .20 | 25,000 | 17.5 Cents plus 25 Per Cent of Increase over 40 Cents per M. c. f (6) |
| Various Independent Producers | ..... (1) | 350,000 (2) | .10 | 35,000 | 10 Cents per M. c. f. (6) |
| Total Purchased Gas | | 2,720,000 (2) | $ 0.2514 | $ 683,750 | |
| Red Bush Production | | 100,000 (2) | ..... | ..... | |
| Total Gas Purchased and Produced | | 2,820,000 (2) | | $ 683,750 | |
| Estimated Total Gas Sales | | 2,190,032 (3) | | | |
| Estimated Loss and Company Usage | | 219,003 | | | |
| Total | | 2,409,035 | | | |
| Balance: Gas Stored in Ground | | 410,965 | $ .1213 (5) | $ 49,850 | |
| Gas Purchased Account | | 2,409,035 | $ .2631 | $ 633,900 | |
| Estimated Retail Gas Sales in Lexington District: | | | | | |
| M. c. f. | | 1,245,568 (4) | | | |
| As Per Cent of Total Gas Sales | | 56.87% | | | |
| Cost of Gas Allocated to Lexington District | | | | $ 360,499 | |

NOTES: (1) Company Exhibit No. 6, p. 15, Col. 1 (R. 143)
(2) " " No. 6, p. 15, Col. 2 (R. 143)
(3) See detail sheet (Statement No. 2 attached)
(4) Company Exhibit No. 6, p. 11, Col. 9 (R. 139)
(5) Company Exhibit No. 6, p. 15, Col. 3 (R. 143)
(6) Company Exhibit No. 6, p. 15—"Basis of Contract price per M. c. f." (R. 143)

## STATEMENT NO. 4

### Estimate of Federal Income Tax

| | *With Proper Allowance for the Cost of Petroleum Exploration Gas.* |
|---|---|
| Gross Revenue | $ 628,726 (1) |
| Less: | |
| Expenses— | |
| Field and Main Line | $ 33,024 (1) |
| City Plant | 47,681 (1) |
| General | 16,596 (1) |
| Gas Purchased | 360,499 (1) |
| Total Expenses | $ 457,800 (1) |
| Extraordinary Maintenance | |
| Central Ky. Nat. Gas Co. | 10,000 (1) |
| Lexington Utilities Co. | 5,000 (1) |
| Other Taxes Paid | |
| Franchise Tax | 14,620 (1) |
| Tangible Property Tax | 6,694 (1) |
| Miscellaneous Deductions | 8,400 (2) |
| Total Expenses and Deductions | $ 502,514 |
| Net Revenue Subject to Federal Income Tax | $ 126,212 |
| Federal Income Tax (13½%) (3) | $ 17,039 |

NOTE: (1) See Statement No. 1, preceding Column 3

(2) Company Exhibit No. 6, p. 17, Col. 3 (R. 144)

(3) As used in Company Exhibit No. 6, p. 17 (R. 144)

STATEMENT No. 1—Item "Gas Sales" (explained in Statement No. 2).

In concluding that a 50 cent rate would be reasonable the court used the company's actual figures for 1927. Gas sales amounted to $606,912 in 1927. (Company Exhibit No. 8, p. 6, R. 155). The quantity of gas sold in 1927 was 1,175,954 M. c. f. (Company Exhibit No. 8, p. 8, R. 157). But 1927 was an unusually warm year. In a normal year the quantity of gas sold at 50 cents would be 1,245,568 M. c. f. (Company Exhibit No. 6, p. 11, R. 139). The revenue would be $622,784 as shown in Statements Nos. 1 and 2.

STATEMENT No. 1—Item "Gas Purchased" (explained in Statement No. 3).

The next figures in Statement No. 1, to which attention is directed, are those opposite "Gas Purchased," in the third column, $360,499. This figure is based on the inclusion of Petroleum Exploration gas, and is explained in detail in Statement No. 3. The difference between this figure and the figures appearing in Statement No. 1, columns 1 and 2, $269,703 as "gas purchased" which was the actual figure for 1927, and used in the court's estimate of net income, are due to the same causes, to-wit: the requirement of 1,245,568 M. c. f. as of a normal year consumption instead of 1,175,954 actual for 1927, and to show the quantity and cost of gas purchased from the various producers.

STATEMENT No. 1—Item "Federal Income Taxes" (explained in Statement No. 4).

The court in using 1927 figures adopted the item of Federal Income tax, amounting to $4,699.00 based upon a net income of $98,307 (Company Exhibit No. 8, page 15, column 4, R. 167). Statement No. 4 correctly computes the income tax under a 50 cent rate, on the basis of including the cost of the Petroleum Exploration gas. This tax would be $17,039 as contrasted with the above figure of $4,699 used by the court.

## The Rates Promulgated by the Company

(Errors VIII, XV, XVI, Points V, IX)

### (a) Under the Express Terms of the Franchise Contract the Appellant Has the Right to Fix Its Own Rates and Charges Provided Only They Are Reasonable—a Flat Rate Is Discriminatory and Unjust to Both Company and Consumers

The Franchise Contract, the result of long negotiation and careful preparation, provides in Section 4(A) (R. 32):

> "Sec. 4(A) The Company shall have the *right* to charge, demand, collect and receive for its gas service just and reasonable rates, charges or compensation."

Appellant contends it has the right under both the State law and the contract to determine its own schedule of rates, and the form thereof. Such schedule may contain a minimum and service charge, a higher commodity rate for

smaller quantities of gas and lower rates for larger quantities. In other words, the company may put into effect a promotional type of rate. The only limitation upon this right is that the rates must be reasonable. If the net income derived under such rates is insufficient to produce a fair rate of return on the fair value of the company's property neither the commission or court may lawfully interfere with such rates or compel the company to accept a flat rate, since under such form of rate gas sales would be less. Mr. Kimball testified that the company's net income would be less under a flat rate of 60 cents than it would be under the appellant's promulgated rates which average 60 cents (R. 133).

The court may take judicial knowledge of the fact that Lexington is near large bituminous coal fields and that the fuel (natural gas) which the company has to sell comes into keen competition with coal. Unless the company is permitted to have a minimum and service charge, and to charge higher rates for the first few thousand feet of gas used for cooking and water heating (and worth for such purposes considerably more than for space heating by reason of its great convenience and instant service), the ability of the company to compete with coal for heating is seriously impaired. Gas for heating is considerable of a luxury, and unless the price can be made low enough to induce the average consumer to use gas instead of coal the company's main source of revenue will be curtailed.

The principles on which block rates for utility service are based, and the discriminatory character of a flat rate, are well known and need neither explanation nor supporting argument. (*U. S. Light & Heat Co.* v. *Niagara Falls Gas & Electric Light Co.*, 23 F. (2d) 719.) It is obvious

that a flat rate operates as a discrimination against the substantial user by making him carry the small or convenience user who in the absence of a minimum or service charge would be carried at an operating loss. Such loss would necessarily have to be made up from the substantial user if the company is to have an adequate revenue.

In the recent case of *Citizens' Committee* v. *Kings Lighting Co.*, P. U. R. 1933 B, 151, the New York Public Service Commission held a flat rate for gas economically unsound and discriminatory. In the opinion written by Chairman Maltbie it was said:

> "After many months of extended hearings and lengthy and detailed consideration, the Commission decided upon a form of rate for the two companies just named which provided for initial blocks of consumption, a minimum bill of $1 and follow-on rates for all consumption in excess of the initial blocks. The Commission held that the amount in the initial block and the follow-on rate should in all fairness be varied according to the peculiar facts applicable to each company. In the case of the Brooklyn Union Gas Company, the initial block was made 600 cubic feet and the follow-on rate was 95 cents; in the case of the Brooklyn Borough Gas Company, the initial block was 500 cubic feet and the follow-on rate $1.05. In many other cases which have been considered affecting other areas throughout the state, the Commission had made its determinations consistent with the decisions in the two Brooklyn cases, holding that the Commission is in duty bound to treat all utilities alike and to apply the same principles to other cases which were decided upon after so many hearings and such long consideration given to the matter in the Brooklyn cases.
>
> . . . . . .

> The Kings County Lighting Company has asked in its petition that the Commission continue the form of rate now in effect, which is a flat price per thousand cubic feet, with no minimum bill or initial block. *The Commission determined in the two Brooklyn cases referred to that this form of rate was unfair, would interfere with the proper development of the gas business, and did not equitably distribute among the various classes of users the cost of the service.* To continue the flat rate would be to reverse the previous determinations of the Commission, and our experience with the new forms of rates justifies no such reversal of policy." (Id. 152-153)

Independently of the company's contract right to fix its own rates and charges the Kentucky statute expressly recognizes such right (Section 201e-2, Appendix, p. 91). The statute permits a change by the commission only in case of extortion (Section 201e-14, Appendix, p. 92). This statute also makes it the duty of the Railroad Commission to correct discriminations and prevent undue advantages (Section 201e-5, 11, Appendix, pp. 91, 92).

Appellant insists that under and by virtue of the "right" created by the contract, as well as a right recognized by statute, it may promulgate its own form of rates; that it should not be required to charge a flat rate, and that its own promulgated rates cannot be lawfully disturbed unless shown to be "excessive."

**(b) The Company's Promulgated Rates Are Just and Reasonable**

Pursuant to the requirement of the franchise contract, Sec. 4(B) (R. 32), the company promulgated the following schedule of rates:

60 cents net (63 cents gross) minimum charge including the first 100 cu. ft. per month;
6 cents net per 100 cu. ft. for the next 900 cu. ft. per month;
60 cents net (63 cents gross) per 1000 cu. ft. for the next 4000 cu. ft. per month;
50 cents net (53 cents gross) per 1000 cu. ft. for all gas in excess of 5000 cu. ft. per month.
(averaging 60 cents—Opinion R. 86—Kimball, R. 149)

The appellant in paragraph 8 of its Motion for special Findings of Fact (R. 94) requested a finding that the promulgated rates were just and reasonable from and after the date of the franchise contract (February 25, 1927), and that any lower rates would be confiscatory (Error VIII, Point V).

In view of the fact that from the contract date to December 1, 1927, the temporary rate was only 50 cents, the right of the company to a higher rate for that period is of no practical moment, and the reasonableness of the company's rates averaging 60 cents need be considered only from and after December 1, 1927, when the company began furnishing gas through the second pipe line and the cost of the Petroleum Exploration gas first became an annual operating expense in the amount of $300,000, and by reason of which the temporary rate went to 60 cents under the franchise contract.

Appellant maintains that since this cause comes up on both the law and the facts, *i. e.*, on its merits, this Court may and should find that the company rates are just and reasonable, and direct the lower court to enter a decree to that effect. *Story Parchment Co.* v. *Patterson Parchment Paper Co.*, 282 U. S. 559, 568.

This branch of the argument is therefore directed to the testimony of Mr. Kimball (R. 145 to 154), explaining the grounds and reasons for his estimate of net revenue fully set forth in Company Exhibit No. 6, *supra*. The Court is asked to note that this estimate, carefully and logically worked out, is the only one introduced or offered by either side. Mr. Kimball's method and basic facts on which his estimate was made were never contradicted or challenged. While the various computations in this Exhibit may be somewhat difficult to follow, the principles on which they are based are readily comprehended, and we shall briefly explain the essential features of this Exhibit.

The quantity of gas sold depends on weather conditions. It was necessary therefore to ascertain the differences in consumption caused by temperature conditions in the "winter" months.

It was also necessary to determine the effect on consumption caused by the increase in the rate from 40 cents to 50 cents. This computation is found on page 10 (R. 138-b) and shows that on account of the increase in rate from 40 cents (1920-1925) to 50 cents (1926 and 1927) there had been a decrease in consumption.

On page 11 (R. 139) is shown (column 1) the actual consumption in 1927 as 1,175,954 M. c. f., but corrected to mean temperature conditions the consumption under the temporary rate of 50 cents would have been 1,245,568 M. c. f. (column 9). On the same page is shown the estimate that on a further increase from the temporary rate of 50 cents to the company's promulgated rates (averaging 60 cents, which is equivalent to the temporary rate fixed by the parties), there would be a further decrease in sales in a normal year; and that the total sales in the Lexington

district under the 60-cent rate would be 1,152,150 M. c. f. (column 9).

Having thus arrived at the estimated annual consumption in a normal year for the Lexington district, Mr. Kimball then calculated the gross revenue that would be derived therefrom under the company's promulgated rates. The result shows that in a normal year the company would derive a gross revenue under its 60-cent (average) rate of $691,670 (p. 6, column 14, R. 136-a). To this is added the revenue from Gasoline, Shop, Interest and Miscellaneous $9,606, being the average revenue from these sources for the years 1924-1926, inclusive (Exhibit 6, p. 13, R. 141), thus making the total gross revenue for the Lexington district $701,276 (R. 134).

The expenses (other than for purchased gas) represent the average for the years 1924-1926, inclusive (R. 142). These figures were also adopted by the city (Carter's Exhibit 8, Sheet 1, R. 191).

The only disputed item of expense appearing in Mr. Kimball's exhibit was that of "Gas Purchased," being $673,250 (R. 143) for the entire system, and $379,848 for the Lexington district (R. 134). The details supporting this estimate of the cost of gas appear on page 15 of Exhibit 6 (R. 143). The sources of purchased gas are there shown. The estimated quantities of gas that would be delivered by the various companies furnishing gas, the prices thereof, and the total cost is developed. The principal sources of supply as shown on this page are United Fuel Gas Co. (its contract calling for a minimum of 720,000 M. c. f. per annum) and the Petroleum Exploration (being the annual minimum of 750,000 M. c. f.), the Hillsdale Gas Co., with a contract minimum of 720,000 M. c. f. (R. 143),

but which the evidence shows had been unable to deliver that amount (R. 118-a, 165), and, therefore, the delivery by that company, as well as the deliveries by all other producers, was estimated on the basis of prior annual deliveries (Exhibit 4, R. 118-a).

The city offered no estimate of its own, although it had the services of an exceptionally able accountant, Mr. John Jirgal of Chicago, who testified to the historic cost of the company's property, and who also estimated the cost of reproduction as of December 31, 1926, and as of December 31, 1927.

Appellant therefore contends that the Kimball estimates based on the company's gas purchase contracts and the actual experience of the company should have been accepted by the court as correct in the absence of any suggestion or testimony by any witness showing any error in method or in the company records.

The remaining item of expense was "Taxes" amounting to $34,636 for the Lexington district (R. 134, 144).

The total amount claimed by the company for amortization, etc., was $121,530 (R. 145). The court allowed $75,263, being $46,267 less than claimed by the company (Opinion, R. 88). The following statement shows the net income under the promulgated rates, adjusted to the allowances made by the court:

| | |
|---|---|
| REVENUE: | |
| Gas Sales | $691,670 |
| Gasoline, Shop, Interest and Miscellaneous | 9,606 |
| TOTAL | $701,276 |
| OPERATING EXPENSE: | |
| Field and Main Line Expense | 28,464 |
| City Plant Expense (Exclusive of rental) | 41,946 |
| General Expense | 21,839 |
| Gas Purchased | 379,848 |
| TOTAL | $472,097 |
| Net Operating revenue before deduction for Taxes, Amortization, Depletion, Extraordinary Maintenance, Contingencies, Interest and Dividends | 229,179 |
| *Taxes*: | |
| Franchise Tax | 14,620 |
| Tangible Property Tax | 6,694 |
| Federal Income Tax | 13,322 |
| | $34,636 |
| Net Operating Revenue before deduction for Amortization, Depletion, Extraordinary Maintenance, Contingencies, Interest and Dividends | 194,543 |
| AMORTIZATION, ETC. (ESTIMATED) | |
| Amortization and Depletion: | |
| Central Ky. Nat. Gas Co. | 82,477 |
| Lexington Utilities Co. | 12,191 |
| Extraordinary Maintenance: | |
| Central Ky. Nat. Gas Co. | 12,878 |
| Lexington Utilities Co. | 8,384 |
| Contingencies: | |
| Central Ky. Nat. Gas Co. | 5,600 |
| TOTAL | $121,530 |
| Net Income Available for Interest and Dividends | 73,013 |
| Add: Amount by which the Kimball allowances for Amortization, etc. were reduced | 46,267 |
| Available for Interest and Dividends | 119,280 |
| Rate Base (by Court) | 2,198,107 |
| Return | 5.42+% |

(See, also Statement No. 1, column 4, *supra.*)

## Fair Return

(Error XIII, Point VIII)

One of the issues involved in this case is what rate of return the company (appellant) is entitled to earn upon its investment or property used in rendering natural gas service to the residents of Lexington, Kentucky.

The Court below held that a 7 per cent rate of return was adequate. There was no evidence to support such finding. It can be justified only upon the theory that a court may (contrary to the undisputed evidence on the subject) take judicial notice of the proper rate of return for any given utility. We have found no case holding that a court may under the doctrine of judicial notice determine and fix the rate of return (a question of fact) to which a utility is entitled. The rule appears to be otherwise. In all the reported cases involving the question of rate of return evidence on the subject appears to have been introduced and the decision predicated on such record evidence.

This court has laid down the applicable rules and standards for determining a fair rate of return in a number of cases. In *Bluefield Co.* v. *Pub. Serv. Comm.*, 262 U. S. 679, 692-693, it was said:

> "What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on invest-

ments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties."

In the recent case of *United Railways* v. *West*, 280 U. S. 234, 251-252, this Court observed that a rule cannot be laid down "which will apply uniformly to all sorts of utilities. What may be a fair return for one may be inadequate for another, depending on circumstances, locality and risk." The Court also said:

> "It is manifest that just compensation for a utility, requiring for efficient public service skillful and prudent management as well as use of the plant, and whose rates are subject to public regulation, is more than current interest on mere investment. Sound business management requires that after paying all expenses of operation, setting aside the necessary sums for depreciation, payment of interest and reasonable dividends, there should still remain something to be passed to the surplus account; and a rate of return which does not admit of that being done is not sufficient to assure confidence in the financial soundness of the utility to maintain its credit and enable it to raise money necessary for the proper discharge of its public duties. In this view of the matter, a return of 6.26 per cent. is clearly inadequate. In the light of recent decisions of this Court and other Federal decisions, it is not certain that

> rates securing a return of 7½ per cent. or even 8 per cent. on the value of the property would not be necessary to avoid confiscation."

The natural gas industry operates under more hazardous conditions for investors than other public utilities. As was said by the Supreme Court of New York in *Pennsylvania Gas Co.* v. *Public Service Commission,* 207 N. Y. Supp. 599, 611:

> "The hazards of the natural gas business are also relevant facts in determining what will constitute a fair return."

Rate of return has to do with attracting capital to an industry or business, and judged by the attitude of investors (past and present) toward natural gas companies the rate of return of such utilities must be considerably higher than that of others to make their securities attractive. The necessity for allowing a higher return to natural gas companies because of the extra hazard and uncertainty of the business (it being a mining venture of limited life—dependent upon a wasting asset) is quite generally recognized by Public Service Commissions and Courts.

In *Re Ashtabula Gas Company,* P. U. R. 1917 D, 790, 795-796, the Ohio Commission, in allowing a ten (10%) per cent return to the company, said:

> "The natural gas business differs materially from that of any other which is classed as a public utility. Its production is in the nature of a mining venture. It can be produced only in limited areas, and when once discovered, it is only by continuous mining that the extent of the field can be ascertained and the supply maintained.

Electricity may be produced anywhere that the machinery can be installed. Water may be found either on or below the surface, everywhere save in the desert. Telephonic communication and railway transportation may be indefinitely carried on anywhere, and all of these services may be perpetually furnished, but natural gas is limited to comparatively few localities, and the life of the enterprise depends upon the uncertain supply of nature. Experience has taught that at best a field cannot last longer than two or three decades. Those who engage in the venture must get their money back within a few years or not at all, and those who enjoy the luxury must pay a sufficient sum to enable the producer to do so, or capital will not be attracted to such ventures.

*Because of the hazard and uncertainty of the business, c mmissions and courts have recognized the justness of granting to a gas company a higher rate of return on its investment than is given to other utilities* which furnish a commodity whose cost of production can be ascertained with reasonable certainty and whose business can be perpetuated."

In *Re Baker Natural Gas Utility*, P. U. R. 1921 E, 609, 627-628, the Montana Commission said:

"Eight per cent seems now to be the minimum for all ordinary public utility investments in our jurisdiction (In Re Missoula Street Railway Company, 14 M. U. R. ....., Decided December 7, 1920), and eleven or twelve per cent can not be too much for a capital outlay of many thousands of dollars in materials and appliances which may be reduced in value to zero 'in the twinkling of an eye.' If natural gas, 'the element and best natural fuel known to man' is to be put to its highest use, household con-

> sumption, efforts in this behalf must be liberally rewarded (U. S. Dept. Interior, Bureau of Mines, Tech. Papers, 40-69, p. 19), and this has been done quite uniformly and without support from 'war causes.' "

In the case of *Wichita Gas Company* v. *Public Service Commission of Kansas,* decided January 5, 1933, ..... F. (2d) ....., P. U. R. 1933 B, 225, it was held that any return less than 8 per cent would be confiscatory. The court said:

> "We are of the opinion that a return of approximately eight per cent upon present values is necessary under present conditions to assure confidence in the financial soundness of the Cities Service Gas Company, to maintain its credit, and to enable it to raise money necessary for the discharge of its public duties, and that any return substantially lower than eight per cent would be confiscatory" (P. U. R. 1933 B, 233).

In response to the contention that the return should be less because the times were abnormal, it was said:

> "The witness for the Commission testified that 8 per cent would not be an unreasonable return in normal times, but testified that these times are abnormal, as they are. But if abnormality is considered, the return must be increased, not decreased. In these times, when stock of the best utilities can be purchased on a 9 per cent basis or better, certainly an 8 per cent return on this hazardous enterprise is not unreasonable." (P. U. R. 1933 B, 254.)

The only testimony offered on this question was on behalf of the appellant. Mr. Kimball testified that in his opinion this company should have a return of 10 per cent. (R. 151). No witness was called by the city to give any

opinion concerning the proper rate of return. It is fair to assume that the city made due inquiry as to what rate of return would be necessary in order to induce capital to invest in the capital stock and business of appellant and ascertained from well-informed persons it would require at least a 10 per cent return to attract investment funds to a natural gas enterprise in this locality, as otherwise testimony to the contrary would have been introduced.

The appellant contends it was not open to the Court to disregard the evidence and fix a 7 per cent rate of return. But assuming for the sake of the argument that the Court could rightfully ignore the evidence and determine the rate of return solely on the basis of judicial knowledge, it seems clear that a 7 per cent return would be confiscatory for a natural gas company, exposed as it is to hazards that do not attend the business of other public utilities.

In the case of *Western Oklahoma Gas & Fuel Co.* v. *State,* 113 Okla. 126, 129, the Supreme Court of Oklahoma approved a return of 16 per cent for a natural gas company. And in *United Fuel Gas Co.* v. *Railroad Commission,* 13 F. (2d) 510, affirmed in *United Gas Co.* v. *Railroad Commismission,* 278 U. S. 300, the Court approved an allowance of over 16 per cent for return, depreciation and amortization. In the latter case, 13 F. (2d) 510, 524, the District Court (Eastern District of Kentucky) said:

> "It is urged by the company that the rate should be made up of at least 10 per cent representing interest upon investment and profits, and 6 per cent to cover depreciation and depletion. While we are of the opinion that 5 per cent in this particular case will amply cover depreciation and depletion, and that 10 per cent profit is perhaps high, the contention of the complainants may here be conceded, with-

> out varying the result at which we have arrived. * * * A 9 per cent return upon the appreciated valuation claimed, of $66,000,000, which we assume to be ample, would closely approximate 16 per cent return upon the rate base here found."

In a number of comparatively recent decisions it has been held that a rate of return of not less than 8 per cent was necessary in order to avoid confiscation for water, electric light, telephone and artificial gas utilities. We cite the following typical cases:

*Southwestern Bell Telephone Co.* v. *City of Ft. Smith,* 294 Fed. 102, affirmed in 270 U. S. 627;
*Brush Elec. Co.* v. *Galveston,* 262 U. S. 443;
*Louisiana Water Co.* v. *Public Service Commission,* 294 Fed. 954;
*Consolidated Gas Co. of New York* v. *Prendergast,* 6 F. (2d) 243, affirmed in *Ottinger* v. *Consolidated Gas Co.,* 272 U. S. 576;
*Springfield Gas and Electric Co.* v. *Public Service Commission of Missouri,* 10 F. (2d) 252;
*Brooklyn Borough Gas Co.* v. *Prendergast,* 16 F. (2d) 615, 622.

Even in the case of the railroads where Congress has passed limiting legislation, this Court has indicated that a return of around eight per cent is necessary is avoid confiscation. See *Dayton-Goose Creek Ry. Co.* v. *U. S.,* 263 U. S. 456, 486.

In *Denver Union Stock Yard Co.* v. *United States,* 57 F. (2d) 735, 745, the court held that 7½% return was the minimum allowance for a company engaged in a non-hazardous business. The court said:

"The Secretary found that 7½ per cent was a fair return. The petitioner introduced evidence that the capital structure of such a property as the petitioner's would involve bonds, preferred stock, and common stock; and by a compilation of the interest and dividend rates that would be necessary on all securities, arrived at the conclusion that anything less than 10 per cent. on the full valuation would be an unreasonably low rate. This means that the common stock, carrying the risk of the entire investment, would receive much in excess of 10 per cent. But we do not think that the return upon property used and useful should be increased or decreased because of the capital structure of a particular owner. We think the Secretary's method of allowing a percentage upon the value of the property used and useful in the public business, without respect to the capital structure, is permissible. Otherwise the rates of two identical properties would vary accordingly as one owner had issued bonds or preferred stock and the other owner had not. It seems to us that a 7½ per cent. return is a minimum. *It must be remembered that no return at all is assured; the effect of the order is to grant permission to earn that sum, if the owner is able so to do.* We have some doubt whether, as conditions are presently, capital could be attracted from investments which assure 5 or 6 per cent. backed by a large margin of safety, to an enterprise which offers only a permission to earn a maximum of 7½ per cent. The history of the petitioner discloses considerable fluctuations in earning power from year to year. While we have doubt whether a permissive rate of 7½ per cent. is sufficient to attract capital, it is, after all, a matter of opinion, and we resolve the doubt in favor of the Secretary's finding. The Secretary knows what a vital service these stockyards render

> to his particular charges, the farmers and the cattlemen; he knows the hardship that it would entail if they were deprived of the services of such institutions."

As said by this Court in *Public Service Commission of Montana* v. *Great Northern Utilities Company*, ..... U. S. ....., decided April 10, 1933:

> "The due process clause of the Fourteenth Amendment safeguards against the taking of private property, or the compelling of its use, for the service of the public without just compensation. Reagan *v.* Farmers' Loan & Trust Co., 154 U. S. 362, 410. Smyth *v.* Ames, 169 U. S. 466, 546. Wilcox *v.* Consolidated Gas Co., 212 U. S. 19, 41. Missouri Pacific Ry. Co. *v.* Tucker, 230 U. S. 340, 347. The Minnesota Rate Cases, 230 U. S. 352, 434. Board of Comrs. *v.* N. Y. Tel. Co., 271 U. S. 23, 31. But it does not assure to public utilities the right under all circumstances to have a return upon the value of the property so used."

Until recent years there was but a negligible quantity of natural gas securities on the investment market. It is practically impossible to find any published literature, except of very recent date, on the subject of utility financing which make reference to natural gas companies. In an article on the "Measurement of Risk in Public Utility Industries" published in the February and August, 1930 issues of the Journal of Land and Public Utility Economics, Mr. John F. Reinboth demonstrates that the difference in the yields of the bonds of various classes of utilities is the true measure of the investor's estimate of the risks inherent therein. He shows the direct relationship between the in-

vestor's opinion of the risk inherent in the particular kind of utility service and the yield on its bonds. Mr. Reinboth compares the yields on the six dominant classes of public utility bonds to the yields on municipal bonds during the period from 1909 to 1929, but nowhere in the whole study is there any reference to natural gas issues. This is an indication of the limited demand for natural gas securities in the investment world.

There is little in common between the financial structure of a utility and an industrial concern. The utility is designed and financed to serve not the average continuous demand, but the maximum demand of its consumers at all times. It must serve not only those whom it may economically reach, but all persons in the community. A large industrial consumer may close its doors during times of depression, but the utility must be in position to render adequate service at all times to its remaining patrons.

The utility's investment has but little relation to its annual earnings. In the usual manufacturing enterprise the entire capital may be "turned over" several times a year, and the value of its yearly product may approximate the capital investment; while in the case of a utility the capital turn-over is slow and the value of the annual product is never more than a fraction of its invested capital. Also, the industrial company is free to change at will the type of its activities while the utility is restricted by its franchise to rendering a particular service under rigid conditions. This, of course, means a much higher capital investment and a more substantial financial venture for the public utility investor.

It is necessary to fix a rate of return sufficiently high to attract capital to the business in order that a utility may

properly discharge its duties to the public. Only in this way can its credit be supported and its financial soundness preserved. Money invested in a hazardous business commands a rate of return commensurate with the degree of risk in the enterprise. As stated in *Louisiana Water Co.* v. *Public Service Commission,* 294 Fed. 954, 957 "no rate of return can be deemed reasonable which is not high enough to attract capital to the form of investment involved in utility properties." In *Willcox* v. *Consolidated Gas Co.,* 212 U. S. 19, 49, the Court said:

> "One who invests his money in a business of a somewhat hazardous character is very properly held to have the right to a larger return, without legislative interference, than can be obtained from an investment in government bonds or other perfectly safe security."

And in *McCardle* v. *Indianapolis Co.,* 272 U. S. 400, at page 419:

> "It is obvious that rates of yield on investments in bonds plus brokerage is substantially less than the rate of return required to constitute just compensation for the use of properties in the public service. Bonds rarely constitute the source of all the money required to finance public utilities. And investors insist on higher yields on stock than current rates of interest on bonds. Obviously, the cost of money to finance the whole enterprise is not measured by interest rates plus brokerage on bonds floated for only a part of the investment. The evidence is more than sufficient to sustain the rate of 7 per cent found by the commission. And recent decisions support a higher rate of return."

If it be urged that a 7 per cent return is sufficient because of the extraordinary business depression which exists at the present time, the appellant answers that there was no economic depression in this country in February, 1927, at which time the reasonableness of the rates promulgated and collected by it is to be considered and determined. In this connection, we also invite attention to the recent decision of the Alabama Commission in *Smith* v. *Birmingham Gas Co.*, P. U. R. 1932 B, 241. In its opinion in that case (at pp. 245-247) the Commission said:

> "The question raised in this proceeding, i. e., 'Why utility rates should not decline in company with falling commodity prices,' is one that has been asked by many consumers of utility service in recent months. It is a very natural inquiry under present conditions, and it is pertinent to the issues in this case, to point out some of the fundamental differences between public utility business and private enterprises.
>
> The Alabama public utility act was enacted in October, 1920. Under the law, it is the duty of the commission to supervise rates of the utilities, as well as their securities and standards of service. The commission requires periodic reports of their revenues, operating expenses, and capital expenditures, and through its staff, the commission makes inspections of the operations and operating records of such utilities.
>
> Under the commission's regulation, utilities are prevented from charging more for their services than will provide a reasonable return upon the fair value of their property devoted to the public use.
>
> On the other hand, unregulated industrial and commercial enterprises are free to charge for their products all that can be obtained during prosperous

times. The limit to their price of profit is determined by supply and demand.

In the case of regulated utilities, the regulation of rates and control of return is exercised to the end that rates, at all times, be maintained at a reasonable level. Were the utilities unregulated, as is true of private enterprises, if they were free during prosperous times to fix rates without regulatory control, then they could with justice, perhaps, be subjected to the price fluctuations suffered by private business during economic depressions. If, however, they have not been permitted to earn more than a fair return during prosperous times, this fact must be given due consideration when we deal with their rates and their rate of return during periods of general business depression.

It must be apparent, therefore, to every thinking man, that public utilities cannot be subjected to the sharp price fluctuations which are incident to private business.

In connection with this subject, it must be remembered that the ordinary commercial enterprise turns its capital over several times each year. The utilities turn their capital over once in four to ten years. Thus fixed charges, taxes, depreciation, and interest, being determined by the amount of the capital or investment required to conduct the business, are very high for utilities, as compared with the usual commercial and industrial establishments. These fixed charges make up from fifty to seventy per cent of the cost of furnishing utility service. They cannot be reduced during period of smaller output and sales of utility service. In fact, taxes continue to increase every year.

The remaining costs of utility service, comprising thirty to fifty per cent of the total, do not for reasons we have pointed out and for other reasons ap-

parent, afford the opportunity for the same proportion of reduction of total operating cost resulting from decrease in commodity prices as applies in cases of most private enterprises.

There is another important difference between utilities and private business. In hard times like the present, the private business ceases to borrow money, immediately curtails expenses by cutting down production or by refusing to buy, unless the price is satisfactory, and, if necessary, closes up shop and awaits more prosperous times. The public utility because of its obligation to continue to serve and to render adequate service, is greatly limited as to the extent to which it can go in making any such economies."

It will be noted that the Railroad Commission made no finding in respect to what constitutes a fair return for appellant. The finding of the court below on this question, not being based upon or supported by the evidence, should be set aside.

## A Permanent Injunction Should Have Been Granted

In its opinion handed down July 11, 1932, 60 F. (2d) 137, 141 (R. 89), the court said:

> "We are not determining future values, nor do we undertake to fix a rate of return applicable to a changed valuation or to any future situation involving changes in the consumption of gas, cost of operation and the like. We think, however, that *the 45 cent rate* promulgated by the Commission, as applicable to the date herein involved, December 31, 1926, *is inadequate and must be regarded as confiscatory.*"

In its decree entered September 22, 1932 (R. 99), the court said:

> "Fifth: That the forty-five cent rate for gas fixed by the Railroad Commission by its order entered on October 9, 1929, will not yield a seven per cent rate of return and is found to be inadequate and invalid; and plaintiff is entitled to an injunction restraining its enforcement, but only if the plaintiff will do equity by consenting to or requesting the return to its customers in Lexington all of sums impounded under the order of this court and other tribunals in excess of a reasonable charge as more fully indicated herein below.
>
> * * * * * * * *
>
> Seventh: That by an opinion filed herein on July 11, 1932, which opinion is made a part of this decree, it was provided, among other things, as follows:
>
> 'An order of injunction, enjoining the enforcement of the Commission's order, will accordingly be issued, provided the plaintiff file in this court in ten days a written request that this court order all funds in excess of the 50 cent rate impounded under its orders distributed to and among the consumers of the plaintiff in Lexington entitled thereto, and provided further that it file in this court within ten days satisfactory evidence that it has made written request of the Railroad Commission of Kentucky and of the Fayette Circuit Court of Kentucky that those tribunals make like orders of distribution of all funds in excess of the fifty cent rate which are impounded and held under their orders.'
>
> That before the ten days elapsed, the complainant filed its petition for a modification and/or amendment of the opinion; that on July 29, 1932, an order was entered by the court overruling said petition, and that said order gave the complainant a further

extension of ten days from said date wherein to exercise its option as aforesaid, and that on August 6, 1932, the complainant filed with the court a written statement declining to accept the condition set forth in the option."

Although expressly finding that the commission rate was "inadequate and * * * confiscatory," and "inadequate and invalid" the court refused to grant a permanent injunction against its enforcement.

Appellant contends that the court misapplied the equitable maxim that, "He who seeks equity must do equity." The contract entered into between the parties, as also the issue presented by the pleadings and facts in this case, left no room for the application of the equitable maxim. The maxim presupposes that the defendant has an equity which cannot be protected unless the relief sought by plaintiff is granted on such terms as will protect the defendant's equity. In the absence of an equity in the defendant the maxim can have no proper application. The city, and the consumers represented by the city, possessed no equity which needed protection. The parties had in the franchise contract created and provided their own code of equity pending the final determination of just and reasonable rates. It was agreed in Section 4(E) (R. 32) that the temporary rate of 60 cents and the impoundment thereunder should continue as long as this controversy should be pending in any court.

The requirement imposed by the court as a condition to granting the injunction protected no equity in the city, and was extremely inequitable to the company. It was equivalent to a demand that the company not only acquiesce in the opinion expressed by the court that a 50 cent rate

for gas would be reasonable, and consent to a distribution of the impounded fund on that basis; but also compelled the plaintiff to forego and surrender its legal right to appeal from the decree. If the appellant had thus voluntarily consented to accept a 50 cent rate and had requested a distribution of the impounded funds on that basis, it could not complain of a decree entered thereon and therefore could not appeal therefrom or otherwise obtain a review of the decision.

The defendants (appellees) were not asserting any right to be protected against the continued collection of the temporary 60 cent rate pending an appeal. On the contrary, the defendant Attorney General for the State of Kentucky (an appellee herein), specifically stated in Paragraph VIII of the Answer (R. 52) that:

> "Upon the contrary the defendant Cammack avers and states that he will abide * * * by the contract provision of the franchise set up with the bill, by which plaintiff Company has the right to collect, pending litigation, 60 cents per thousand for its gas sold in Lexington, and that he, the defendant Cammack, specifically disclaims any purpose to take any legal steps whatsoever as against plaintiff Company with respect to said 45 cent rate as long as said contract provision is in force."

Furthermore, the Answer, in Paragraph X, alleged on behalf of each and all of the defendants as follows:

> "Defendants, and each and all of them, further aver and state, and now by their pleading here bind themselves to, and agree that they will in all respects be held and bound by the said 60 cent *pendente lite* agreed rate, and that they expect to, and will, take

no steps of any nature or kind to evade or avoid the said agreement, or to put into application the 45 cent rate named in the said order of the Railroad Commission of October 9th, 1929, as long as the said matter is under litigation, as is provided in said franchise contract; * * *''

The parties having agreed that the temporary rate of 60 cents, and the impoundment thereunder, should continue until the final determination of just and reasonable rates and charges ''by the highest court to which the same may be taken,'' a court of equity could not, in the proper exercise of its discretionary power, impose as a condition to the granting of equitable relief that the plaintiff seeking relief from an admittedly illegal rate order should surrender its rights under the law of the land and a contract deliberately entered into by the city. By the terms of Section 4(E) (R. 32) Franchise Contract until the final determination of the rate controversy the company was to be protected by the collection of the temporary rate of 60 cents. On the other hand the city and the consumers were to be protected by the impoundment of 10 cents collected under said rate. This was the mutual equity and protection thereof agreed to by the parties.

''A maxim of equity will not be applied for the purpose of defeating equity.'' 21 C. J. 172, (Sec. 150).

''The maxim should be applied only to cases where the result that would be worked out without its aid would be against equity and good conscience. The party seeking relief is not required to sacrifice his own rights.'' 21 C. J., 175 (Sec. 152).

''Thus it cannot be successfully invoked to overthrow a plain contract voluntarily entered into with

knowledge of all the facts." 21 C. J., page 178 (Sec. 156).

A case in point on this question is *Pottenger* v. *Bond* (Ind.), 142 N. E. 616, wherein the court, at page 621, says:

> "While we recognize that courts of equity, in granting relief, are not circumscribed by any fast or technical rules, and hence have a broad discretion in framing their decrees, in order to adopt the relief to the circumstances of each particular case, there are limits beyond which even a court of equity may not go. One of such limitations is stated in a recent legal treatise as follows:
>
> 'It is not the province of a court, however, to change the terms of a contract which has been entered into, even though it may be a harsh and unreasonable one. Nor will the dictates of equity be followed if by so doing the terms of the contract are ignored, for the folly or wisdom of a contract is not for the court to pass upon. Its terms, however onerous they may be, must be enforced if such is the clear meaning of the language used, and the intention of the parties using that language.' 13 C. J. 541.
>
> See also, Pittsburgh, etc. Co. *v.* Lake, etc., Co., 118 Mich. 109, 76 N. W. 395; Cody, etc. Co. *v.* Coach, 76 Or. 406, 146 Pac. 973; Pine, etc. Co. *v.* Crystal, etc., Co., 65 Fla. 254, 61 South. 576. Should it be urged that this general rule is not without its exceptions, our answer would be that no facts are found which would warrant the application of an exception. The contract is not unconscionable or its methods of performance impracticable. Its terms are not even harsh, and certainly no facts are found which tend to excuse a substantial compliance."

What is said of the contract involved in the last cited case can certainly be said of the contract in this case. It would be difficult to devise provisions more inherently equitable than those in the Franchise Contract, preserving as they do the rights of both parties in the impounded funds pending the final fixation of rates, providing for the ultimate distribution thereof, and also preserving to both sides the lawful right of appeal.

The "equity" which must be done by the party seeking equity is well defined in the case of *Otis* vs. *Gregory,* 111 Ind. 504, 13 N. E. 39, where the Court said:

> "Accepting the maxim above referred to as in the highest degree authoritative, it becomes proper to inquire concerning the manner of its application in the practical adjustment of controversies between parties. What is the 'equity' which a party appealing to a court of chancery must do before he is entitled to relief? Can a party who becomes plaintiff in a court of equity be compelled, as the price of the relief demanded, to surrender to the defendant something which the latter could not have compelled by some proceeding, either at law or in equity, in case the former had not appealed to the court? If he can, then the rule that he who would have equity must do equity depends for its application in each case upon the arbitrary notions of the chancellor concerning the equities between parties. The effect of such an application of the rule would inevitably, in many cases, be to refuse aid to which a plaintiff would be entitled, except upon condition that the latter should concede to the defendant some supposed equitable right which was not enforceable at law or cognizable in a court of equity, and, hence, not within any description of a legal or equitable right."

Many additional cases illustrating and supporting the principle announced in the foregoing authorities could be readily assembled, but we are convinced there is no necessity for this.

A court of equity may undoubtedly grant a temporary injunction on terms against an apparently confiscatory rate pending final disposition of the case on the merits. The following cases offer appropriate illustrations:

*City of Toledo* v. *Toledo R. R. & Light Co.*, 259 Fed. 459;

*Consolidated Gas Co.* v. *Newton*, 267 Fed. 231, affirmed in 258 U. S. 165;

*Public Service Railroad Co.* v. *Board*, 276 Fed. 979.

But in each of those cases there was a corresponding equity which demanded protection. The parties had not stipulated or agreed upon an arrangement as between themselves which would afford such protection as they have in the instant case.

There was no necessity for the court to impose upon this appellant such a harsh and inequitable condition as a prerequisite to granting a permanent injunction against the commission rate. In order to determine the rights of the parties it was merely necessary for the court below to decide that the Railroad Commission rate was confiscatory and enjoin its enforcement; and order a distribution of the impounded funds on the basis of the rate found by it to be reasonable. Such a decree would have been a determination of the rights of the parties in the impounded fund and would have left them equally unhampered in the exercise of their lawful right of appeal. Pending such appeal the

collection of the temporary rate and the impoundment thereunder would have fully protected their respective rights. It is submitted that the court improperly applied the equitable maxim and that the condition imposed as a prerequisite to the granting of a permanent injunction against the commission rate was arbitrary and not a valid exercise of the court's discretionary power.

## Appellant Should Not Have Been Ordered to Pay the Costs

In sub-paragraph (a) of paragraph Eighth of the decree, the Court orders:

> "(a) That the prayer for a permanent injunction herein be and the same is denied with costs to be paid by the complainant to the several defendants to be taxed" (R. 100).

So much of this decree as directs the appellant to pay the costs is contrary to and violative of the contract between the parties. The franchise provides (R. 38):

> "Sec. 35. The cost of conducting all hearings instituted by the City or by the Company before the Railroad Commission, court or other tribunal, to which both the City and Company are parties shall be paid equally by the City and the Company; but each shall pay all fees and expenses of all witnesses, experts and lawyers engaged or called by it."

It seems clear that the agreement of the parties should govern this matter.

**The Appellee, City of Lexington, Has Caused to Be Certified and Printed a Large Portion of the Record Which Is Not Essential to This Appeal, on the Theory That It May Without Taking a Cross-Appeal Urge Errors Alleged to Have Been Committed Against It by the Trial Court**

The appellant is moved to enter a protest or complaint against the bringing up from the lower court and the required printing by the Clerk in this Court at the instance of appellees of many pages of the transcript which are not essential to this appeal, thereby enlarging the record unnecessarily and adding to the labors of this Court.

The portion of the printed record referred to appears at pages 193 to 246, no part of which is essential to the consideration of any of the Errors assigned or any of the Points upon which appellant relies in this appeal.

An examination of the portion of the record in question will disclose that the evidence embraced therein applies to the following matters and contentions made by the City of Lexington in the court below:

(a) That appellant was not entitled to any allowance whatever for amortization.

By making an allowance for amortization the court decided against the city's contention.

(b) That from and after the intercorporate relation arose between the Columbia Gas & Electric Corporation, the United Fuel Gas Company and the appellant by reason of the acquisition by the Columbia company of the capital stock of the appellant, the Columbia being then the owner of all of the capital stock of the United Fuel Gas Company,

the appellant should not be permitted to charge into operating expenses the contract price paid by it to the United Fuel Gas Company for gas purchased under a twenty-year contract made with that company in November 1912; and that because there was proof that the prevailing price in Kentucky and West Virginia for gas at the well was from ten to twelve cents, the appellant should not be allowed to charge into operating expenses more than 12½ cents per M. c. f. for the gas purchased by it from the United Fuel Gas Company at Inez, Kentucky.

The court below disallowed the city's contention on the ground that the contract between appellant and the United Fuel Gas Company was made at arm's length and at a time when there was no intercorporate relation.

(c) The city further contended in the lower court that the appellant had the legal right to terminate all of its gas purchase contracts with other producers (except Petroleum Exploration) wherein the prices were in excess of 12½ cents; and inasmuch as the United Fuel should be required to furnish all of the gas which appellant might need at 12½ cents, the latter should not be permitted to charge into operating expense the contract price paid by it for gas under these gas purchase contracts with other producers, or any price in excess of 12½ cents.

The court below accepted as correct the actual operations for 1927, which are fully set forth in Company Exhibit No. 8 already discussed, thereby sustaining the right of appellant to charge into operating expenses the prices paid by it under these several gas purchase contracts. By necessary implication therefore the city's contention was overruled.

No error was assigned by the appellant as to any of the above matters. Appellant has accepted the court's rate base, its allowance for amortization, and its ruling on all of the gas purchase contracts other than the contract with Petroleum Exploration. Hence in this appeal none of the testimony relating to said matters was or is essential. The City of Lexington did not appeal from the decree of the lower court and, of course, has not assigned any errors to the rulings of the lower court.

However, the appellant has been put on notice that the city claims the right to ask this Court to consider the rulings of the court below on the above matters. This contention is predicated upon the power of this Court to consider rulings of the lower court presented by the record and urged by the appellee as error without a cross-appeal provided appellee's contention would operate to sustain the decree.

In support of its right to include the portions of the record objected to by appellant as not essential and to urge upon this Court as errors the rulings of the lower court on the above points, the city relies upon *United Railways* v. *West,* 280 U. S. 234, and *Langnes* v. *Green,* 282 U. S. 531.

We apprehend the substance of the contention for the city will be that conceding the lower court was in error in not making a proper allowance for the cost of the Petroleum Exploration gas (amounting to $300,000 per annum, as admitted by the city) yet such error is counter-balanced by other errors made in the company's favor. Appellant contends that it is not open to the appellee to urge such alleged errors in this appeal because the city has no itself appealed. We are not unmindful that this may be a matter for the exercise of judicial discretion (see *United States* v.

*Henry Prentiss & Company,* ..... U. S. ....., decided January 9, 1933), but conceding the power of the court in the premises the question remains whether the record presented on which the court is requested to consider the alleged errors is such as will enable it properly to exercise such power. Before referring to recent decisions of this Court which appear to sustain our position, we invite attention to the record which has been brought here.

Inasmuch as the appellant assigned no error to the rulings of the lower court on amortization and gas purchase contracts, it did not include any of the evidence on those points (other than such as bears on the Petroleum Exploration contract) because none of that evidence was germane or essential to the appeal.

However, the appellee has caused to be certified and printed *some* of the evidence bearing on said matters. The court thus has in the record brought here only the evidence which the city desired for its present purpose, and which is limited to the evidence introduced by the city on the subject matter. It does not contain any of the evidence introduced by the appellant on these subjects. This is apparent on the face of the printed record.

The order entered in the court below filing the Railroad Commission record on which this cause was submitted sets out in detail the contents of that record and all of the Exhibits (R. 77 to 82). This order shows that there was filed Company Exhibit No. 4 on Net Revenue available for return, etc. This exhibit was prepared and testified to by Mr. Kimball. In the printed Record (R. 113) appears the complete index to this Exhibit which sets out the following subject headings.

Summary of Estimated Annual Allowance Necessary for Amortization, Depletion, Extraordinary Maintenance and Contingencies ..... 28
Details of Estimated Annual Allowance Necessary for Amortization and Depletion, and the Proportion Allocated to the Lexington District ..... 33
Details of Estimated Annual Allowance Necessary for Extraordinary Maintenance and Proportion Allocated to Lexington District ..... 39

As no part of the exhibit covering the above topics was essential to the appeal those parts were omitted therefrom in obedience to Equity Rule 75, as well as all of the testimony of Mr. Kimball directed to said matters. Nor did appellant include any of the city's evidence on this subject, which consisted of the lengthy essay of Mr. Beckner on the subject of the geology of Eastern Kentucky and the writer's optimistic "prophecy" as to the total amount of gas that might some day be discovered in all Eastern and Southeastern Kentucky. As rebuttal to this purported evidence for the city on the subject of gas reserves, the appellant introduced Mr. James A. Yunker, a *practical* and experienced gas engineer, who filed an exhibit showing his estimates of gas reserves ("Exhibit Yunker's No. 1—Gas Reserves in Eastern Kentucky"). Since this exhibit and Mr. Yunker's testimony was not essential to this appeal, they were omitted by the appellant in its Statement of Evidence.

It thus appears that the record now here contains the city's evidence on the subject of gas reserves (relied on by it as affecting appellant's right to amortization), but none of the evidence introduced by the appellant. Under this state of the record it seems clear that this Court is not in position to determine the validity of the city's contention

that the court below erred in making any allowance whatever for amortization.

It will be necessary to consider only four of the decisions of this Court which appellant relies on as stating both the rule and the limitations thereon.

In *United States* v. *American Railway Express Co.*, 265 U. S. 425, the Court said:

> "The Southeastern insists that these claims, although adequately presented in the bill of complaint, cannot be availed of in this court because they were overruled by the district court and the American did not take a cross appeal. The objection is unsound. It is true that a party who does not appeal from a final decree of the trial court cannot be heard in opposition thereto when the case is brought here by the appeal of the adverse party. In other words, the appellee may not attack the decree with a view *either to enlarging his own rights thereunder or of lessening the rights of his adversary,* whether what he seeks is to correct an error or to supplement the decree with respect to a matter not dealt with below. But it is likewise settled that the appellee may, without taking a cross appeal, urge in support of a decree *any matter appearing in the record* although his argument may involve an attack upon the reasoning of the lower court, or an insistence upon matter overlooked or ignored by it. By the claims now in question, the American does not attack, in any respect, the decree entered below. It merely asserts additional grounds why the decree should be affirmed. These grounds will be examined."

It seems apparent that the city can not now be permitted to urge that the court below was in error in making any

allowance for amortization because that involves an attack on the decree for the purpose of lessening the rights of the appellant, as well as with the view of enlarging the city's rights. Furthermore, we invite attention to the words "any matter appearing in the record." Does this mean *fully* appearing, with all of the evidence on the subject, or only *partially* appearing with the evidence of only one side?

In *United Railways* v. *West*, 280 U. S. 234, 253, it was said:

> "The commission sought a review of the question in respect of the annual depreciation allowance, both by a cross-appeal and, later, by petition for certiorari. The question of jurisdiction on the cross-appeal as well as the consideration of the petition for certiorari was postponed to the hearing on the merits. We do not now find it necessary to decide either matter. As the amount of depreciation to be allowed was contested throughout, is a necessary element to be determined in fixing the rate of fare and is closely related in substance to the case *brought here by the company's appeal*, it well may be considered in connection therewith. In these circumstances neither cross-appeal nor certiorari is necessary to present the question."

It appears that the record brought to this Court in the *West* case contained at least all that was necessary to enable it to pass on the question raised.

In *Langnes* v. *Green*, 282 U. S. 532, 535, 538, the Court said:

> "The preliminary objection is urged by petitioner, that, since the decision below upon this point was against respondent and he has not applied for certiorari, the point is not open here for considera-

tion; but the objection is without merit, as a brief review of the decisions of this court will disclose.

* * * * * *

These decisions simply announce a rule of practice which generally has been followed; but none of them deny the *power* of the court to review objections urged by respondent, although he has not applied for certiorari, if the court deems there is good reason to do so. In the present case, however, it is not necessary to consider this rule of practice because the respondent offers no objection to the decree of the court of appeals. In that court he attacked the decree of the district court upon the two grounds above stated, and the circuit court of appeals sustained the attack but upon one of such grounds only. Respondent here defends that decree upon the ground upon which it was based, and, in addition, continues to urge the rejected ground, not to overthrow the decree, but to sustain it. His right to do so is beyond successful challenge, quite apart from the fact that this is a proceeding in admiralty, and is here from an intermediate appellate court. * * * And, obviously, the right or duty of this court to consider these additional grounds will neither be affected by their rejection in the court below, nor be made to depend upon the effect finally given to them here."

In *Halbert* v. *United States,* 283 U. S. 753, 764, this Court said:

"So far as can be determined from the record the district court rightly applied the rules stated in this opinion. *The record does not purport to contain, and evidently does not contain, all the evidence that was produced on the hearing.*

* * * * * *

> It is thus rather plain that the statement of evidence contains only so much of the evidence as was deemed essential to the decision of the latter. We now are asked to consider questions not raised by the assignment of errors and *which cannot be properly decided without appropriate assurance that the record contains all the evidence that is material to their decision.* We must decline to consider them."

The city urges that the court below was in error in allowing in operating expenses the contract price paid by appellant to United Fuel Gas Company after the intercorporate relation arose (January 1, 1928). The city contends that the acquisition of appellant's capital stock by the Columbia company created a legal unity or identity as between the appellant, the Columbia, and the United Fuel; and that such alleged identity had the legal effect not only of extinguishing the contract between the appellant and the United Fuel Gas Company, but also gave the city the right to require the latter company (with which the city had no contract) to furnish all the gas appellant might need at 12½ cents per M. c. f. by reason of the claim that gas was selling at the well in Eastern Kentucky and in West Virginia at from 10 to 12 cents.

The city's theory seems fantastic. A contract made in 1912, valid and enforceable on February 25, 1927 when the company and the city made their franchise contract, is not converted into a device or scheme to render a rate confiscatory that would be otherwise lawful by reason of the purchase of the appellant's capital stock by the Columbia company in 1928. Such purchase could not possibly affect the validity of existing contracts between the appellant and other companies.

The remaining alleged error which the city proposes to urge, although it did not appeal, is that the appellant could lawfully abrogate or cancel all of its gas purchase contracts and refuse to receive any more gas under them; and on the basis of this assumed premise the appellant should not be allowed to charge into operating expenses more than 12½ cents for the gas purchased under these contracts by reason of the further assumption that the city has the right to compel the United Fuel Gas Company to furnish to the appellant all the gas it may need over and above what it is required to purchase from Petroleum Exploration. This proposition is even more untenable than the first one.

Whether the appellant, if it attempted to terminate its gas purchase contracts would be subjected to suits for damages or for specific performance and might as a result be compelled to take and pay for such gas, does not seem to be considered as of any importance by the city in the application of its theory. Furthermore, the prevailing price of gas at the well in Eastern Kentucky and West Virginia can have no bearing on this matter. It was not shown nor is it claimed that there is any gas available to the appellant except that which it now purchases from the various producers with which it has contracts.

Neither commission nor court will attempt to control the judgment of the company's officers in the management of its affairs. In *Southwestern Bell Telephone Co.* v. *Public Service Commission,* 262 U. S. 276, 289, it was said:

> "It must never be forgotten that while the state may regulate, with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies, and is not clothed with the general power of management incident to

ownership. The applicable general rule is well expressed in State Public Utilities Commission *ex rel.* Springfield *v.* Springfield Gas & E. Co., 291 Ill. 209, 234, P. U. R. 1920 C. 640, 125 N. E. 891:

> 'The commission is not the financial manager of the corporation, and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by the corporate officers.' "

Nor will a commission or court condemn a contract between inter-related companies in the absence of bad faith. In *United Fuel Gas Co.* v. *Railroad Commission,* 278 U. S. 300, 320, the court said:

> "We recognize that a public service commission, under the guise of establishing a fair rate, may not usurp the functions of the company's directors and in every case substitute its judgment for theirs as to the propriety of contracts entered into by the utility; and common ownership is not of itself sufficient ground for disregarding such intercorporate agreements when it appears that, although an affiliated corporation may be receiving the larger share of the profits, the regulated company is still receiving substantial benefits from the contract and probably could not have secured better terms elsewhere."

The inter-relation between the appellant, the Columbia company and the United Fuel did not affect the separate corporate identity of the appellant or establish a corporate unity between these companies. *Smith* v. *Illinois Bell Telephone Co.,* 282 U. S. 132,

But even if these contentions had merit it would not now be open to the city to urge them as it has not appealed from the decree of the lower court.

## Conclusion

The appellant submits the following:

1. The court below having found the Commission rate confiscatory should have granted a permanent injunction against the enforcement of its order.

2. The cost of the Petroleum Exploration gas should be allowed in operating expenses from and after December 1, 1927, as of which date such added expense began and the agreed temporary rate of 60 cents went into effect.

3. The return fixed by the court is inadequate for a natural gas utility. The only testimony in the record is that the company was entitled to a 10 per cent return. It was not open to the court to disregard the evidence.

4. The court below having found that a 50 cent rate was reasonable under operating conditions existing over the period of the 50 cent temporary rate the funds impounded thereunder should be turned over to the company.

5. Under the State law and the express terms of the Franchise Contract the company has the right to fix its own rates so long as they are not excessive, and the record conclusively shows that allowing for the cost of gas purchased from Petroleum Exploration the rates promulgated by the company will yield a return

of only 5.42% on the rate base fixed by the court. This rate averages 60 cents, and is equivalent to the 60 cent temporary rate agreed upon by the parties. The company's rates being reasonable, the funds impounded under the temporary rates should be released to it.

It is respectfully urged that the rates promulgated by the company pursuant to the provisions of the Franchise Contract should be adjudged the lawful rates during the period here in question; that the decree appealed from be reversed, and the court below directed to enter a decree permanently enjoining the enforcement of the commission's order and delivering to appellant the impounded funds collected under the temporary rates.

Respectfully submitted,

HENRY T. DUNCAN,
DYKE L. HAZELRIGG,
CHESTER J. GERKIN.

Lexington, Kentucky,
April 20, 1933.

# APPENDIX

## Kentucky Constitution

*Section 163:*

"No street railway, gas, water, steam heating, telephone, or electric light company, within a city or town, shall be permitted or authorized to construct its tracks, lay its pipes or mains, or erect its poles, posts or other apparatus along, over, under or across the streets, alleys or public grounds of a city or town, without the consent of the proper legislative bodies or boards of such city or town being first obtained; but when charters have been heretofore granted conferring such rights, and work has in good faith been begun thereunder, the provisions of this section shall not apply."

*Section 164:*

"No county, city, town, taxing district or other municipality shall be authorized or permitted to grant any franchise or privilege, or make any contract in reference thereto, for a term exceeding twenty years. Before granting such franchise or privilege for a term of years, such municipality shall first, after due advertisement, receive bids therefor publicly, and award the same to the highest and best bidder; but it shall have the right to reject any or all bids. This section shall not apply to a trunk railway."

## Kentucky Statutes

(Revised Edition 1930)

*Section 201e-2:*

"Every company distributing, furnishing or selling natural gas in this state shall print and publish, in legible form, a schedule showing the rates charged for natural gas furnished or sold by it in the different cities of this state and a copy of such schedule shall be filed with the railroad commission and with the city clerk or recorder of each city so furnished, and such schedule shall at all times be opened to public inspection."

Section 201e-5:

"Whenever a duty or obligation is imposed upon any company mentioned in this act by law which relates to the rates, tolls, fares, classification, charges, service, rules, regulations or practice of any such company, or whenever a complaint is filed alleging a violation of this or any other law relative to such company, the same shall be under the supervision and regulation of the railroad commission which shall have authority, after due notice and hearing as provided by law, to issue an order fixing just and reasonable rules or regulations or practice to be thereafter followed and to prescribe the rate of toll to be charged or service to be performed thereafter to relieve any undue or unreasonable discrimination, prejudice or advantage found to exist in violation of law; and such rates, classifications, charges, fares, tolls, rules, regulations or practice so ordered shall be substituted for the rates, classifications, charges, fares, rules, regulations or practice then in force by any such company, and power

is by this act conferred upon said commission to make and put into effect joint rates."

Section 201e-11:

"It shall be unlawful for any such company to make or give any undue or unreasonable preference or advantage to any particular person or locality or any particular discription of traffic in any respect whatever; or to subject any particular person, company, firm, corporation or locality or any particular description of traffic to any undue or unreasonable prejudice or disadvantage, or to make or give any undue or unreasonable preference or advantage to any particular person or locality in the transmission of messages, or to subject any particular person, firm, company, corporation or locality to any undue or unreasonable prejudice or disadvantage in the distribution, furnishing or sale of natural gas, or to subject any such person or locality to any undue or unreasonable prejudice or disadvantage."

Section 201e-14:

"When a complaint shall be made to the Railroad Commission accusing any express company, telephone company, or telegraph company, or natural gas company, mentioned in the act of charging or collecting or receiving extortionate rates for transportation of property or for the transmission of messages, or for telephone boxes, over its line or lines in this commonwealth or for the distribution, furnishing or sale of natural gas in this commonwealth, or when said commission shall receive information or have reason to believe that such rate or rates of toll or tolls are being charged, collected or received, it shall be the duty of said commission to hear and determine the matter as speedily as possible, provided, that as to any telephone

company said complaint shall be signed by at least five of its *bona fide* patrons. Said commission shall give the company complained of not less than ten days' notice, by letter mailed to an officer or agent of said company, stating the time and place of the hearing of same, also the nature of the complaint or matter to be investigated, and shall hear such statements, arguments or evidence offered by the parties as the commission may deem relevant, and should the commission determine that the company is or has been guilty of extortion, said commission shall make and fix a just and reasonable rate, toll or compensation which such company may charge, collect or receive for like services thereafter rendered. The rate, toll or compensation so fixed by the commission shall be entered and be an order on the record book of their office signed by the commission, and a copy thereof mailed to an officer or agent of the company affected thereby, and be in full force and effect at the expiration of ten days thereafter, and may be revoked or modified by an order likewise entered of record."